UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES LITIGATION	Civil Action No. H-01-3624 **(Consolidated)**
This Document Relates To:	CLASS ACTION
MARK NEWBY, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, vs. ENRON CORP., et al., Defendants.	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., Individually and On Behalf of All Others Similarly Situated, Plaintiffs, vs. KENNETH L. LAY, et al., Defendants.	

MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO MOTION TO DISMISS BY CITIGROUP

85

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES **Page**

Page

Page

Page

Page

STATUTES, RULES AND REGULATIONS

SECONDARY AUTHORITIES

LEGISLATIVE HISTORY

I. INTRODUCTION AND FACTUAL OVERVIEW[1]

In the face of a 500-page complaint alleging the largest and worst securities fraud in the history of the United States[2] in excruciating detail, every single defendant – Enron's insiders, Enron's outside directors, Enron's accountants, Enron's lawyers and Enron's banker – has moved to dismiss. Some claim it is too long. Some claim it is not detailed enough. Everyone denies responsibility. Not one defendant has seen it fit to answer. Every defendant seeks to avoid accountability by raising technical pleading arguments based on the Private Securities Litigation Reform Act of 1995 ("95 Act") which was meant to deter the filing of ***frivolous*** suits – which everyone knows, except apparently the defendants, this case is not. While it does appear that the 95 Act was successful, at least in this case, in deterring plaintiffs' securities lawyers from filing cookie-cutter complaints, it does not appear to have had the same salutary impact with respect to deterring defendants from filing meritless motions to dismiss.[3]

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[1] Because any changes to the pleading requirements were not intended to prevent aggrieved parties from obtaining redress for their valid claims, "courts still apply Rule 12(b)(6) principles to motions to dismiss securities class action cases." *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1166 (W.D. Wash. 1998) (collecting cases); *see also Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1273 n.1 (11th Cir. 1999). Consequently, the Court must accept as true all well-pleaded allegations in the Complaint and construe them in the light most favorable to plaintiff. *Scheuer v. Rhodes*, 416 U.S. 232 (1974); *Calliott v. HFS, Inc.*, No. 3:97-CV-0924-I, 2000 U.S. Dist. LEXIS 4368, at *8 (N.D. Tex. Mar. 31, 2000); *Zuckerman v. Foxmeyer Health Corp.*, 4 F. Supp. 2d 618, 621 (N.D. Tex. 1998) (Maloney, R.) (stressing that "the complaint is to be liberally construed in favor of the plaintiff"); *Young v. Nationwide Life Ins. Co.*, 2 F. Supp. 2d 914, 919 (S.D. Tex. 1998); *Lawal v. British Airways, PLC*, 812 F. Supp. 713, 716 (S.D. Tex. 1992). "A motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b)(6) 'is viewed with disfavor and is rarely granted.'" *Calliott*, 2000 U.S. Dist. LEXIS 4368, at *7. Dismissal is appropriate only if it appears that no relief could be granted under any set of facts that could be proven consistent with the allegations. *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994) (citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)); *Tuchman v. DSC Communications Corp.*, 818 F. Supp. 971, 974 (N.D. Tex. 1993), *aff'd*, 14 F.3d 1061 (5th Cir. 1994); *Calliott*, 2000 U.S. Dist. LEXIS 4368, at *3. All emphasis is added and citations are omitted unless otherwise noted.

[2] *See* John C. Coffee, "Guarding the Gatekeepers," *New York Times*, 5/13/02 at A19, referring to Enron as a "Major debacle of historic dimensions ...."

[3] While the banks all proclaim their innocence and insist that they acted properly, without conflict or corruption, and in accordance with normal commercial lending and investment banking activities, these denials ring hollow in light of the recent revelations of corruption on Wall Street. *See* Marcia Vickers and Mike France, "Wall St.: How Corrupt is it?," *Business Week*, 5/13/02 attached as Ex. 1 to plaintiffs' Appendix.

If it is "irrational" to engage in actions that violate the law then it appears Wall Street is deranged. However, if it is irrational to violate the law because of the risk of financial loss and

CitiGroup Inc. ("CitiGroup") denigrates the detailed Consolidated Complaint ("CC")[4] as a "puzzle pleading" that violates Fed. R. Civ. P. 8. But, the CC is of the same style and format sustained by this Court in *In re Landry's Seafood Restaurants, Inc. Sec. Litig.*, No. H-99-1948 (S.D. Tex. Feb. 20, 2001) – a decision defendants basically ignore – and in many other reported and unreported decisions. The "puzzle pleading" charge has been repeatedly rejected by courts which respect good faith efforts by victims of securities fraud to provide the kind of detail and individuality required by the 95 Act – especially in complex multi-party cases. As Judge Debevoise stated in sustaining a lengthy complaint against a public company and its officers and directors:

> Defendants challenge the Complaint, claiming that rather than being a "short and plain statement of the claim" in conformity with Fed. R. Civ. P. 8, it is "puzzle pleading" that fails to meet the requirements of Rule 9(b) and the Private Securities Litigation Reform Act (the "Reform Act"). ***The Complaint certainly is not short, but if it is a puzzle, it is meant for a child and can be assembled readily.***

In re Honeywell Int'l Sec. Litig., 182 F. Supp. 2d 414, 416 (D.N.J. 2002). In truth, ¶¶1-74 of the CC provide a relatively succinct summary of the CC, while the balance of the CC provides the detail required by Rule 9(b) and the 95 Act, thus satisfying plaintiffs' dual pleading obligations.

CitiGroup[5] portrays itself as a victim of the Enron debacle – a financial institution that was merely rendering "routine commercial and investment banking services" to Enron when it became engulfed in the Enron conflagration. But this is not what is pleaded in the CC, and what is pleaded

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punishment that accompanies illegal conduct, then presumably no one would ever violate the law and acceptance of this after-the-fact rationale would provide all wrong doers from embezzlers to bank robbers to price fixers and sophisticated securities violators with a built-in defense.

The banks elected, as was their right, to each move to dismiss separately and not coordinate their briefs. CitiGroup, and in fact all the banks, in crafting their separate motions to dismiss have largely ignored, and substantially mischaracterized, the factual allegations against them. However, it is the actual allegations of the Complaint and not defendants' mischaracterization of the them that must govern at the motion to dismiss stage. Because the banks have not accurately characterized the nature of the factual allegations and claims against them, we find it necessary to set forth those factual allegations in considerable detail in this opposition brief. Plaintiffs apologize for the length and repetition this approach requires.

[4] All references to "¶¶_-_" are to paragraphs of plaintiffs' CC filed 4/8/02.

[5] CitiGroup is an integrated financial services institution that, through subsidiaries and divisions (such as Salomon Smith Barney), provides commercial and investment banking services and advisory services, including acting as underwriter in the sale of corporate securities and providing investment analysis and opinions on public companies. ¶101.

is what controls in the motion to dismiss context. What the CC pleads and what now must be accepted as true is that CitiGroup is liable under the 1933[6] and 1934[7] Acts because it (i) sold Enron and Enron-related securities via false Registration Statements; (ii) issued false analysts' reports on Enron; (iii) employed acts, contrivances and manipulative or deceptive devices; and (iv) participated in a scheme to defraud or a course of business that operated as a fraud or deceit on, purchasers of Enron's securities between 10/18/98 and 11/27/01 (the "Class Period").[8]

A. Year-End 97 Crisis

The fraudulent scheme and course of business involving Enron finds its origin in mid-97 when Enron suffered huge losses on British natural gas and MTBE transactions which called into question its trading and risk management skills. Analysts downgraded Enron's stock and lowered their forecasts of Enron's future earnings growth. Enron's stock lost one-third of its value and Enron's executives' performance-based bonuses were slashed. Enron was determined to halt its stock's decline and push it back to higher levels. Enron knew this could only be accomplished by reporting stronger-than-expected financial results, thus enabling it to credibly forecast stronger future earnings growth. Unfortunately, Enron's actual business operations were not capable of generating such results. ¶8.

To make matters worse, in late 12/97, Enron learned that an entity it had established with an outside investor – Joint Energy Development Incorporated ("JEDI") – and had done transactions with to generate 40% of the profits Enron reported during 97 – had to be restructured, as the outside investor was going to withdraw from JEDI. This created a crisis. Because the outside investor in JEDI had been independent of Enron, JEDI had ***not*** been consolidated into Enron's financial statements, *i.e.*, Enron did deals with JEDI as an independent party, recognized profits and did not carry JEDI's debt on its books. Thus, unless JEDI could be quickly restructured with a new, independent investor, ***Enron would have to wipe out all of the profitable transactions it had done***

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6 15 U.S.C. §77a, *et seq.*

7 15 U.S.C. §78a, *et seq.*

8 For the reasons stated at ¶¶54-56 of CitiGroup's Memorandum, plaintiffs are no longer pursuing §11 claims on the 7% Exchangeable Notes.

with JEDI in 97 – put JEDI's $700 million debt on Enron's balance sheet – and lose the ability to generate profits from similar such deals with JEDI's successor going forward. ¶9.

However, Enron ***could not find a legitimate buyer for the outside investor's interest*** in JEDI. So Enron quickly formed a new entity – Chewco – which Enron controlled, to buy the outside investor's interest in JEDI. Chewco ***did not have an outside equity investor which was an independent third party. So, Barclays Bank loaned $240 million to Chewco to fund the purchase, requiring a secret guarantee from Enron. Barclays also loaned the money to two straw parties to provide for their purported "equity" investment in Chewco. Because Barclays knew that the purported equity investors in Chewco were, in fact, Enron "strawmen," Barclays required Chewco to support the purported "equity loans" Barclays made to the two "strawmen" via a $6.6 million reserve paid to Barclays***! Because there was no independent outside investor in Chewco, Chewco was required to have been consolidated with Enron and ***all of Enron's 97 profits from transactions with JEDI should have been eliminated***! ¶10.

By the year-end 97 non-arm's-length Chewco transaction Enron avoided a disaster, keeping the previously recorded JEDI profits in place, inflating Enron's 97 reported profits and keeping millions of dollars of debt off its books. Chewco was now also positioned to serve as a controlled entity which Enron could use to do non-arm's-length transactions with, creating at least $350 million in phony profits for Enron and allowing Enron to conceal millions of dollars of debt. ***Having now created its template to falsify Enron's results, between 98 and 01, Enron and other of its bankers would create other secretly controlled partnerships and entities and use them to generate hundreds of millions of dollars of phony profits while concealing billions of dollars of Enron debt.*** ¶11.

B. The 97-00 Successes – Enron's Stock Soars

As Enron reported ***better-than-expected year-end 97 financial results***, its stock moved higher. During 98 through mid-01, Enron appeared to evolve into an enormously profitable high-growth enterprise, reaching annual revenues of $100 billion by 00, with annual profits of $1.2 billion, presenting a very strong balance sheet that entitled it to an investment ***grade credit rating***. By 01, Enron had become the 7th largest U.S. corporation and was consistently reporting ***higher-***

than-forecasted earnings each quarter and forecasting ***continued strong growth***. ¶¶12-13. Enron extolled the success and earning power of its Wholesale Energy trading business ("WEOS"), its retail Energy Services business ("EES") and its Broadband Content Delivery and Access Trading, *i.e.*, intermediation, business ("EBS"). ¶2.

Throughout 98 and 99, as Enron reported record profits and a strong financial position, Enron and Enron's banks, ***including CitiGroup***, stated (¶14(a)):

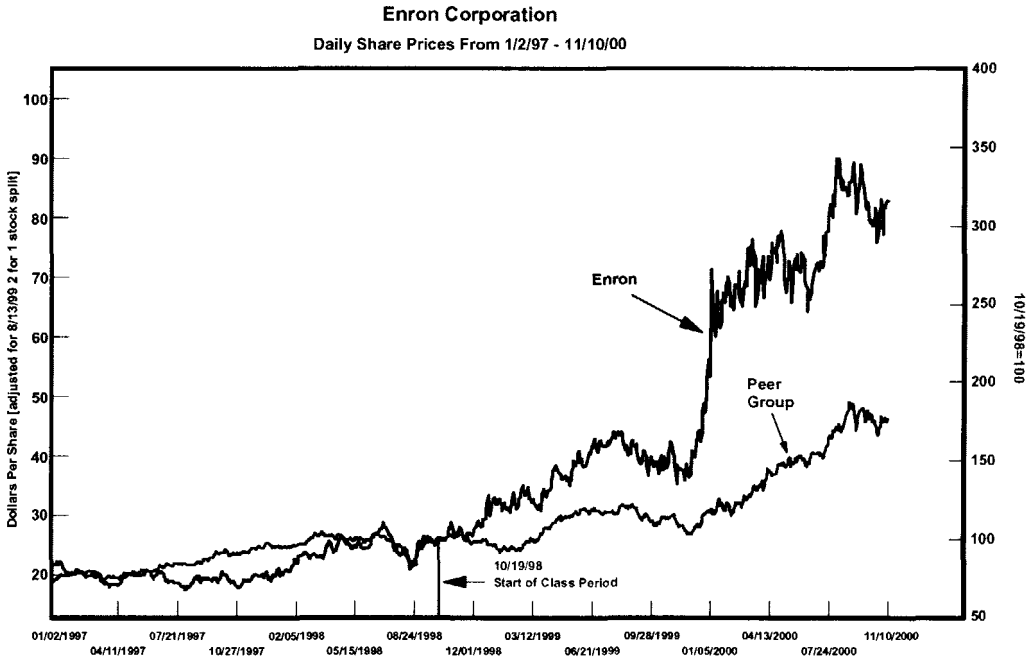
- Enron's strong results were due to the success of all of its business lines.
- Enron had a leading position in each of its businesses. Enron had an extremely strong franchise position.
- Wessex Water would be accretive to Enron's business now and a $20 billion business in five years. Azurix Corp. was becoming a major global water company.
- International projects would drive major earnings growth for Enron. The Dabhol, India power project would contribute to earnings in 99 and beyond.
- WEOS's business remained strong.
- EES was exceeding expectations for contracts and profitability. EES was adding billions in new contracts and would be profitable by 4thQ 00.
- Enron was optimistic about its broadband business. EBS was firing on track.
- Enron's tremendous competitive advantages enabled it to achieve strong EPS growth.
- Enron was very well managed and knew how to manage and mitigate risk. Enron had effectively used off-balance sheet non-recourse financing. Enron had a strong balance sheet. Enron was a master of risk management.
- No other company offered such impressive sustainable growth.
- Enron was hitting on all eight cylinders. Enron's outlook was excellent. Enron was very optimistic.
- Enron was a global powerhouse, with EPS growth to exceed 17%. Enron would maintain strong earnings growth for years.

During 00, as Enron reported record annual profits and a very strong financial position, Enron and its banks, ***including CitiGroup***, stated (¶14(b)):

- Enron's strong financial results were due to strong results in all operations.
- Enron had very strong momentum. Its new trends were sustainable and would accelerate.
- Enron's business was booming. All its operations were gaining momentum.

- Investors were about to see breakout performance of EES and rapid growth and development of EBS.
- EES's new contracts and profitability were accelerating. EES had the potential to double Enron's size in a few years.
- EBS broadband trading was accelerating. The market was larger than expected, and would reach $100 billion in a few years with 3%-4% margins.
- Enron/Blockbuster video-on-demand ("VOD") deal a "killer app." Unparalleled quality of service. Contract worth over $1 billion. VOD to rollout nationally in 01. All components in place. VOD had solid technology and platform.
- Enron's WEOS merchant investments were protected through hedging.
- Enron had monumental earnings potential over the next five years. Enron was well managed and a pioneer in global energy. Enron was never in better shape. Enron was very optimistic about the continued strong outlook for the Company.
- Growth and strong earnings were why investors should buy Enron stock.

As a result of Enron's strong earnings, the positive statements about its business and the forecasts of continuing strong earnings growth, Enron's stock was a very strong performer. ¶15. Enron's apparent success and forecasts of strong profit growth gave Enron and its banks ready access to the capital markets by which they raised billions of dollars by selling newly issued Enron securities to public investors, using the proceeds to repay Enron's bank debt. ¶16. Enron's stock soared to its all-time high of $90-3/4 in 8/00 and then continued to trade at or near these levels for months, as shown below (¶15):



However, the apparent success of Enron was an illusion – a false picture created by contrivances and deceptive acts – a fraudulent scheme and course of business that operated as a fraud and deceit on the purchasers of Enron's publicly traded securities. The fraudulent scheme was accomplished by, *inter alia*, Enron and several banks, including CitiGroup, which pocketed millions of dollars a year from Enron – which by 97-98 had become the ***golden goose of Wall Street***. ¶17.

Inside Enron there was a fixation on Enron's stock and doing whatever was required to generate the financial results necessary to push the stock ever higher. Throughout Enron's corporate headquarters in Houston were TV monitors that displayed the price of Enron stock. Inside Enron there was a saying that managers were to be "***ABC***ing," meaning to "***a***lways ***b***e ***c***losing" deals to generate revenues and profits, even if the economics of the deal were suspect – a practice facilitated by a compensation system inside Enron for corporate managers and executives that directly rewarded them financially for ***closing*** transactions and placing a high (*i.e.*, inflated) value on them, regardless of the true economic substance of the deal, so long as the deal generated an apparent profit when "marked to market." ¶50.

Inside Enron, the pressures applied to corporate managers by the top executives to do anything necessary to enable Enron to make its numbers was widespread, as was the knowledge that Enron's revenues and earnings were being falsified. Former insiders have been quoted as saying "***[y]ou don't object to anything***" and "***[t]he whole culture at the vice-president level and above just became a yes-man culture***."

> But that culture had a negative side beyond the inbred arrogance. ***Greed was evident, even in the early days. "More than anywhere else, they talked about how much money we would make," says someone who worked for Skilling. Compensation plans often seemed oriented toward enriching executives rather than generating profits for shareholders. For instance, in Enron's*** energy services division, which managed the energy needs of large companies like Eli Lilly, executives were compensated based on a market valuation formula that relied ***on internal estimates. As a result, says one former executive, there was pressure to, in effect, inflate the value of the contracts – even though it had no impact on the actual cash that was generated.***

Fortune, 12/24/01 (¶51).

> ***"If your boss was [fudging], and you have never worked anywhere else, you just assume that everybody fudges earnings," says one young Enron control person. "Once you get there and you realized how it was, do you stand up and lose your***

job? It was scary. It was easy to get into 'Well, everybody else is doing it, so maybe it isn't so bad.'"

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The flaw only grew more pronounced as Enron struggled to meet the wildly optimistic expectations for growth it had set for itself. "You've got someone at the top saying the stock price is the most important thing, which is driven by earnings," says one insider. "Whoever could provide earnings quickly would be promoted."

The employee adds that anyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants. She says there was little scrutiny of whether the earnings were real or how they were booked. The more people pushed the envelope with aggressive accounting, she says, the harder they would have to push the next year. "It's like being a heroin junkie," she said. "How do you go cold turkey?"

Business Week, 2/25/02 (¶51). In fact, in mid-8/01, an Enron executive wrote Lay, telling him the Company was "***nothing but an elaborate accounting hoax***," and, in referring to the LJM2/SPE transactions which Enron's banks – including CitiGroup – had structured and funded and CitiGroup had secretly invested in, that nothing "***will protect Enron if these transactions are ever disclosed in the bright light of day***" – warning "***[W]e're such a crooked company***." ¶51.

By 97-98, Enron was a hall of mirrors inside a house of cards – reporting hundreds of millions of dollars of phony profits, while concealing billions of dollars of debt – inflating its shareholder equity by billions of dollars. Enron had turned into the largest Ponzi scheme in history – constantly raising fresh money by selling its securities or those of related entities, while appearing to achieve successful growth and profits. But, because Enron's reported profits were being generated by phony, non-arm's-length transactions and improper accounting tricks – including the abuse of "mark-to-market" accounting[9] to accelerate the recognition of hundreds of millions of dollars of

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[9] Enron engaged in several accounting tricks and manipulations to falsify its financial results during the Class Period. Chief among these was the abuse of "***mark-to-market accounting***" whereby Enron computed the purported profit it would ultimately obtain on a multi-year contract, discount that to present value and recognize the entire "mark-to-market" profit in the current period. Enron misused and abused mark-to-market accounting ***throughout its entire business to grossly inflate its reported revenues and profits***. In Enron's WEOS business this was done by assigning unrealistic values to wholesale energy transactions which inflated current period income. In Enron's EES business where Enron had no long-term track record to justify the use of mark-to-market accounting, Enron nevertheless consistently utilized mark-to-market accounting to record huge current period profits on long-term, highly speculative retail energy risk-management contracts which, in fact, Enron had no basis to project a profit on and in fact knew would likely result in losses. Finally, in Enron's EBS business – also a new business where Enron had absolutely no track

profits to ***current periods*** from transactions in which Enron was only entitled to receive ***cash over many future years*** – Enron was cash starved. Yet to continue to report ***growing*** profits, Enron was forced to not only continue to engage in such transactions and accounting abuses, ***but to accelerate the number and size of such transactions it engaged in***. This created a vicious cycle further exacerbating Enron's need to obtain cash from these transactions. To make matters worse, Enron had capitalized certain controlled entities it was doing phony deals with (including entities CitiGroup was helping to fund via the LJM2 partnerships) with shares of Enron stock and ***had agreed to issue millions of additional shares of its stock to these entities if Enron's stock price fell below certain "trigger prices***," *i.e.*, $83, $81, $79, $68, $60, $57, $52, $48, $34 and $19 per share, ***and to become liable for the debt of those entities if Enron lost its investment grade credit rating***. Because of the "triggers" and the way Enron capitalized these entities, it was absolutely vital to Enron, CitiGroup and the other participants in the fraudulent scheme and course of business that Enron's stock continue to trade at high levels and that Enron maintain its "investment grade" credit rating, otherwise the scheme would unravel. ¶¶18, 20.[10]

Enron became completely dependent on maintaining its investment grade credit rating and a high stock price so that Enron could continue to have access to the capital markets to borrow

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record which would justify the use of mark-to-market accounting – Enron utilized mark-to-market accounting to generate hundreds of millions of dollars of phony current period profits in several transactions. Also, when reviewing those computations on a quarterly basis as it was required to do, Enron consistently ***increased*** the estimated value of the transaction even though subsequent data revealed ***a reduction of the estimated value of the transaction, a practice known within Enron as "moving the curve***." ¶36.

[10] Enron's investment grade credit rating was indispensable. As Enron's CFO stated in a 10/01 conference call, "***We understand that our credit rating is critical to both the capital markets as well as our counterparties***." Earlier, Fastow stated to *CFO Magazine*, "***My credit rating is strategically critical***." This investment grade credit rating gave Enron access to the commercial paper market – a market reserved for America's largest and most creditworthy corporations – so that it could borrow billions of dollars to maintain its liquidity and finance its capital-intensive business. Enron's access to the commercial paper market also meant that Enron's $3 billion commercial paper back-up credit line, arranged by the lead banks – JP Morgan and CitiGroup – ***would likely not be drawn down upon***, thus limiting those banks' financial exposure to Enron. It also meant that Enron and its banks could easily sell debt securities to investors to raise long-term capital, using the proceeds to reduce short-term commercial paper and other bank debt. Enron's investment grade credit rating was critical to the scheme, as only Enron's insiders and its banks knew, because under the terms of the partnership/SPE deals, ***if Enron's debt was downgraded to below investment grade, the debt of those entities would become recourse to Enron, which could cause the house of cards to topple***. ¶19.

billions in commercial paper and to enable it to periodically raise hundreds of millions of dollars of new longer term capital it needed to repay its commercial paper debt and the short-term loans it was receiving from its banks – including CitiGroup – to sustain its business operations and so the stock issuance "triggers" would not be hit which would force Enron into a death spiral. ¶20.

C. The Partnerships and SPEs

To falsify Enron's reported financial results, Enron and its banks engaged in a series of purported "partnership" and "related party" transactions with the entities known as SPEs. A public company that conducts business with an SPE may treat that SPE as if it were an independent entity ***only if it does not control the SPE***. ***And***, at a bare minimum, two other conditions must be met: (i) an owner independent party must make an equity investment of ***at least 3% of the SPE's assets, which must remain at risk throughout the transaction***; and (ii) ***the independent party must exercise control of the SPE***. ¶21.

In 99, Enron created two LJM partnerships (LJM and ***LJM2), which Enron secretly controlled. Enron then engaged in numerous non-arm's-length transactions – contrivances and devices to deceive – with LJM2 and associated SPEs, which inflated Enron's reported profits by more than a billion dollars – at the same time enriching Enron's CFO (Fastow) and Enron's banks or bankers – including CitiGroup – who had been secretly allowed to invest in the LJM2 partnership as a reward for their participation in the scheme – by hundreds of millions of dollars. The reason for establishing LJM2 was that it would permit Enron to accomplish transactions it could not otherwise accomplish with an independent entity, by providing Enron with a buyer of assets that Enron wanted to sell.*** ¶¶23, 29, 646-647.

LJM2 was one of the primary vehicles used to falsify Enron's financial results during 99-01, which was secretly controlled by Enron and used to create numerous SPEs (including the infamous "Raptors") which engaged in numerous non-arm's-length fraudulent transactions with Enron to artificially inflate Enron's profits while concealing billions of dollars of its debt on terms so unfair to Enron that the deals would provide huge returns to the LJM2 investors. ¶24. Because the LJM2 partnership was going to be so lucrative to investors in that entity ***and provide exceptional returns as the Enron Ponzi scheme continued***, Enron decided that in funding LJM2, it would ***allow certain***

high-level officers of Enron's banks to get in on LJM2. The LJM2 partnership offering memorandum by which Enron and Merrill Lynch (which was raising the equity money for LJM2) brought investors into the partnership – ***which was not a public document*** – contained an invitation to benefit from the self-dealing transactions that LJM2 would engage in. It emphasized Fastow's position as Enron's CFO, and that LJM2's day-to-day activities would be managed by Fastow and other Enron insiders.[11] It explained that "***[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities***" and that it "***expects to benefit from having the opportunity to invest [some $150 million] in Enron-generated investment opportunities that would not be available otherwise to outside investors.***" It specifically noted that Fastow's "***access to Enron's information pertaining to potential investments will contribute to superior returns." In addition, investors were told that investors in a similar Fastow controlled partnership (JEDI) that had done deals with Enron like the ones LJM2 would do had tripled their investment in just two years and that overall returns of 2,500% to LJM2 investors were actually anticipated.*** ¶25.

Enron and CitiGroup knew that because LJM2 was going to engage in transactions ***with Enron where Enron insiders would be on both sides of the transactions, the LJM2 partnership would be extremely lucrative – a deal that was virtually guaranteed to provide huge returns to LJM2's investors as the Enron Ponzi scheme went forward.*** ¶24. In short, the non-public LJM2 offering memorandum was an invitation to share in the benefits of non-arm's-length self-dealing transactions with Enron – to loot it. ***Enron's bankers and the top executives of those banks were permitted to invest in LJM2 as a reward to them for their ongoing participation in the scheme – a sure thing for them.*** ¶¶24, 25.[12]

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[11] In fact, Fastow's dual role by which he could self-deal on behalf of the LJM2 partnership with Enron's assets was so important ***that investors in LJM2 were assured that they did not have to make any additional capital contributions if Fastow's dual role ended.*** ¶24.

[12] While Enron's publicly filed reports disclosed the existence of the LJM partnerships, these disclosures did not reveal the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not fully disclose the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and to disguise their substance and import. The

It was indispensable to the scheme that LJM2 be funded by year-end 99 to serve as a vehicle to consummate several deals with Enron before year-end 99 to create profits for Enron in the 4thQ 99 so that Enron could meet and exceed its forecasted 99 earnings. However, as had been the case with Chewco at year-end 97, there was tremendous time pressure and Enron could not complete the formation of LJM2 and raise money from the equity investors in LJM2 by year-end 99 with sufficient capital to enable it to do the desperately needed transactions with Enron. So, in an extraordinary step, on 12/22/99, CitiGroup, even though LJM2 had not yet been fully formed or funded, but knowing that LJM2 was going to be an extraordinarily lucrative investment anyway, advanced $1,500,000 to "pre-fund" LJM2, *i.e.*, many times more than its allocated capital share in LJM2. ¶26. The reason CitiGroup put up the money to pre-fund LJM2 in 12/99 was that it knew enabling Enron to do the 99 year-end deals with LJM2 and its SPEs was indispensable to Enron avoiding reporting a very bad 4thQ 99 – which would have caused its stock to plunge and endangered the fraudulent scheme. These vital year-end 99 deals included:

(a) ***Collateralized Loan Obligations ("CLOs")***. ***On 12/22/99***, Enron pooled purchaser CLO rights and sold the lowest-rated tranche to Whitewing LLP (an Enron affiliate) and LJM2. Whitewing loaned LJM2 the money to purchase its interest in the CLOs. Enron secretly guaranteed Whitewing's investment and loan to LJM2. This transaction allowed Enron to record the sale of millions of dollars in the 4thQ 99 to an entity that should have been consolidated.

(b) ***Nowa Sarzyna (Poland Power Plant)***. ***On 12/21/99***, Enron sold LJM2 a 75% interest in the Nowa Sarzyna power plant. Enron had tried to sell this interest by year-end to an independent buyer but could not find an independent buyer in time, so it used LJM2, which paid $30 million. This transaction moved millions of dollars of debt off Enron's balance sheet. This was a sham transaction. The debt financing required Enron to maintain ownership of at least 47.5% of the equity until the project was completed. However, the lender ***granted a waiver*** of this until 3/31/00, at which time Enron and Whitewing reacquired LJM2's equity interest and repaid that loan.

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disclosures also represented that the related-party transactions were reasonable compared to transactions with third parties when, in fact, they were not. ¶67.

(c) ***MEGS, LLC. On 12/29/99***, Enron sold LJM2 a 90% equity interest in MEGS, a natural gas system in the Gulf of Mexico. This allowed Enron to avoid consolidating the asset at year-end 99, avoiding millions of dollars of debt on Enron's balance sheet. Enron repurchased LJM2's interest in MEGS in early 00.

(d) ***Yosemite. On 12/29/99***, Enron purportedly sold certificates in Yosemite to LJM2, however, in fact, this transaction did not occur until 2/28/00. The transaction was made to appear to occur at year-end 99 to reduce Enron's interest in Yosemite from 50% to 10% so Enron would not have to disclose its ownership of these certificates in Enron's 99 financial statements and that, in effect, Enron owned some of its own debt. On 12/29/99, Condor (an affiliate of Whitewing), which was controlled by Enron, loaned the $35 million to LJM2 to buy the certificates. On 12/30/99, LJM2 transferred the certificates to Condor, satisfying the one-day loan. ¶28.

From 6/99 through 6/01, Enron entered into numerous other non-arm's-length transactions with the LJM partnership. Enron sold assets to LJM2 that it wanted to get off its books on terms that no independent third party would ever have agreed to. ***The transactions between the LJM partnerships and Enron or its affiliates occurred close to the end of financial reporting periods to artificially boost reported results to meet forecasts Enron and other participants in the scheme had been making***. For instance, near the end of the 3rd and 4thQ 99, Enron sold interests in seven assets to LJM1 and LJM2. The transactions permitted Enron to conceal its true debt levels by removing the assets from Enron's ***balance sheet and, at the same time, record large gains. However, (i) as it had agreed in advance it would do, Enron bought back five of the seven assets after the close of the financial reporting period; (ii) the LJM partnerships made large profits on every transaction, even when the asset they had purchased actually declined in market value; and (iii) those transactions generated "earnings" for Enron of $229 million in the second half of 99 out of total earnings for that period of $549 million. In three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against any loss. Thus, the LJM partnerships functioned only as vehicles to accommodate defendants in the falsification and artificial inflation of Enron's reported financial results, while enriching the LJM investors***. ¶32.

These favored investors in LJM2 – like CitiGroup – actually ***witnessed*** a series of extraordinary pay outs from the Raptor SPEs which LJM2 controlled over the next two years – securing hundreds of millions of dollars in distributions from the Raptors to LJM2 and ***then to themselves*** – cash generated by the illicit and improper transactions Enron was engaging in – *i.e.*, the manipulative or deceptive devices – with the Raptors to falsify Enron's financial results. Thus, the banks like CitiGroup – which ultimately put $10 million in LJM2 – who were partners in LJM2 ***were not only knowing participants in the Enron scheme to defraud, they were economic beneficiaries of it – and of the looting of Enron.***[13] ***Had the Enron Ponzi scheme continued to operate for the full life of the LJM2 partnership, Enron's banks would have achieved the stupendous returns they were promised – measured in thousands of percent.*** ¶31. As it was, they made millions. In addition, CitiGroup actually administered the financial affairs of LJM2 during 99-01, *i.e.*, profit distributions and capital calls, and was thus completely knowledgeable about the details of LJM2's deals, finances and distributions to its investors. ¶27.

One "hedging" transaction with LJM in 6/99 involved Rhythms NetConnections ("Rhythms") stock owned by Enron, ***to "hedge" Enron's huge gains in Rhythms stock and enable Enron to create a huge profit. Enron transferred its own stock to the SPE in exchange for a note. But if the SPE were required to pay Enron on the "hedge," the Enron stock would be the source of payment. Other "hedging" transactions occurred in 00 and 01 and involved SPEs known as the "Raptor" vehicles. These were also structures, funded principally with Enron's own stock, that were intended to "hedge" against declines in the value of certain of Enron's merchant investments. These transactions were not economic hedges. They actually were manipulative or deceptive devices devised to deceive and circumvent accounting rules. The economic reality was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron***. Enron and Enron's banks used these contrivances and

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[13] The returns to the LJM2 investors were huge – up to 2,500% on one deal and 51% overall ***in the first year*** of the partnership. ***Skilling has recently told investigators such gargantuan returns were possible only because LJM2, with Fastow at the wheel, was defrauding Enron in the billions of dollars of deals it was doing with Enron so Enron could create false profits and hide billions of dollars in debt***. Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicion of Fraud," *New York Times*, 4/24/02.

manipulative or deceptive devices to inflate Enron's reported financial results. In 99, Enron recognized income of over $100 million from the Rhythms "hedging" transaction. ***In the last two quarters of 00, Enron recognized pre-tax earnings of $530 million on several transactions with the Raptor entities*** out of reported pre-tax earnings of $650 million. These ***"earnings" from the Raptors' deceptive contrivances accounted for more than 80% of the total***! ¶33.

Hedging Enron's investments with the value of Enron's stock created an enormous and unusual motive for the participants in the scheme to keep Enron stock trading at inflated levels. This was because if the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This happened in late 00 and early 01. In 12/00, Enron's gain on these transactions was over $500 million. Enron could recognize these gains – offsetting corresponding losses on the investments in its merchant portfolio – ***only if the Raptors had the capacity to make good on their debt to Enron***. If they did not, Enron would be required to record a "credit reserve," a loss that would defeat the very purpose of the Raptors, which was to shield Enron from reflecting the decline in value of its merchant investments. ¶34.

As year-end 00 approached, two of Enron's LJM2-financed Raptor SPEs were in danger of coming unwound as they lacked sufficient credit capacity to support their obligations. If something was not done to prevent the unwinding of these SPEs, Enron would have to take a multi-million dollar charge against earnings which would expose the prior falsification of Enron's financial results and result in Enron's stock plunging, more and more of the stock issuance "triggers" would be hit, and a vicious down-cycle would kick in. Therefore, Enron restructured and capitalized the LJM2-financed Raptor SPEs at year-end 00 by transferring to them rights ***to receive even more shares*** of Enron stock, creating ever-increasing pressure on Enron and the other participants in the scheme to support Enron's stock price. This artifice enabled Enron to avoid recording a huge credit reserve for the year ending 12/31/00. ¶35.

D. Enron Energy Services ("EES")

Enron and its banks, including CitiGroup, were also telling investors that an area of tremendous growth for Enron was its retail Energy Services business – EES – where Enron purportedly undertook to manage the energy needs of corporate consumers for multi-year periods

in return for fees to be paid over a number of years. Enron and its banks presented this business as achieving tremendous success by constantly signing new multi-million or even billion dollar contracts which allowed EES to exceed internal forecasts and that this division had turned profitable in the 4thQ 99 and was achieving substantial gains in its profitability thereafter. ¶37.

The falsification of Enron's financial results was not limited to non-arm's-length fraudulent partnership and SPE transactions. EES was also actually losing hundreds of millions of dollars. This was because in order to induce large enterprises to sign long-term energy management contracts and "jumpstart" this business so it could appear to obtain huge contract volumes, Enron was entering into EES management contracts which it knew would likely result in huge losses. However, by the abuse of mark-to-market accounting, Enron grossly overvalued the ultimate value of these contracts and created greatly inflated current period profits from transactions which generated little, if any, current period cash, and which would likely actually result in long-term cash out plans and losses. As a letter written in 8/01 to Enron's Board by an EES manager stated just after Skilling "resigned"(¶38):

> One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrongdoings of the various management teams at Enron .... (*i.e.*, ***EES's management's ... hiding losses/SEC violations***).
>
> * * *
>
> ... [I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked.
>
> * * *
>
> ... [I]t will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion.... [T]hey decided ... to hide the $500MM in losses that EES was experiencing.... ***EES has knowingly misrepresented EES['s] earnings. This is common knowledge among all the EES employees, and is actually joked about. But it should be taken seriously***.

E. Enron Broadband ("EBS")

Another purported growth area of Enron's business was its broadband services business – EBS – which consisted of constructing an 18,000-mile fiber optic network which Enron was supposedly successfully building out and engaging in trading access to fiber optic cable capability, *i.e.*, "Broadband Intermediation." Enron and its banks – including CitiGroup – presented ***both parts***

of Enron's broadband business as poised to achieve, and later as actually achieving, huge success, reporting that its fiber optic network was being or had been successfully constructed, was state of the art and provided unparalleled quality of service, and that its broadband trading business was succeeding and achieving much higher trading volume and revenues than expected – *i.e.*, "***exponential growth***." ¶39.

A prime example of the purported success of Enron's broadband content business was its video-on-demand ("VOD") joint venture with Blockbuster Entertainment, announced in 7/00. Enron presented this 20-year agreement as having a ***billion dollar value***, that it was a ***first-of-its-kind product*** whereby consumers would obtain VOD content from Blockbuster in their home as if they were watching the movie on their own VCR (start, stop, rewind) and that this incredible advance in technology was made possible due to the ***high quality of Enron's fiber optic network***. Abusing mark-to-market accounting and using an LJM2/SPE – funded by CitiGroup – Enron recognized an astonishing and bogus $110+ million profit on this deal in the 4thQ 99 and 1stQ 00, even though the project was failing in its test markets because Enron did not have the technology to deliver the product as represented – and which could never have gone forward because Blockbuster did not have the legal right to deliver movies in a digital format, the only format which could be utilized for VOD. ¶40.[14]

F. New Power

Another example of how Enron and CitiGroup falsified Enron's reported results is the New Power IPO in 10/00, by which Enron improperly created a $370 million profit in the 4thQ 00. Enron controlled New Power and owned millions of shares of New Power stock, if Enron and its banks could take New Power public and create a trading market in its stock, then Enron could recognize

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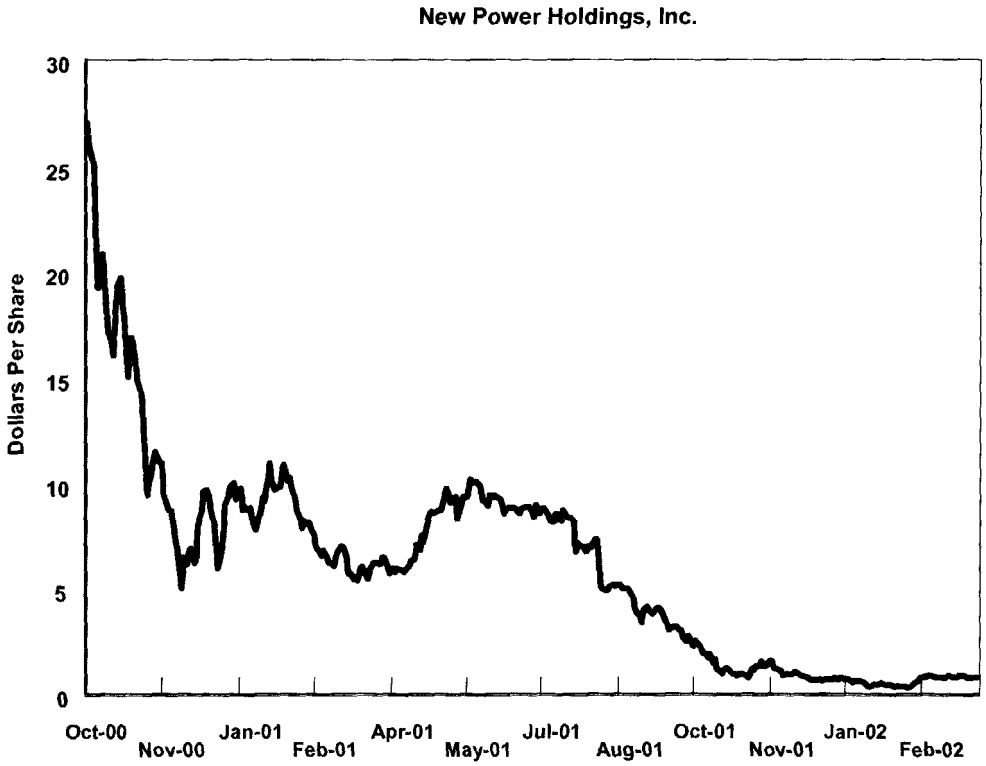
[14] Just eight months after announcing this contract with great fanfare and just weeks after representing that testing of the system in four cities had ***succeeded*** and that the service was being launched nationwide, Enron was forced to abandon the venture. But Enron did not reverse the huge profits it had secretly recorded on this transaction, for to do so would have not only exposed its ongoing abuse and misuse of mark-to-market accounting, but also would have crushed Enron's stock at a time when Enron and the other participants in the scheme were desperately attempting to halt Enron's then falling stock price so that it would not fall below certain trigger prices. CIBC did not force Enron to honor its secret guarantee against losses, as it knew to do so would undermine Enron's fragile financial condition, but rather, carried it as part of its overall exposure to Enron. ¶41.

a profit on the gain in value on its shares by "hedging" that gain via yet another non-arm's-length transaction via LJM2. In the 4thQ 00, Enron desperately needed to create profits to perpetuate the Ponzi scheme. Enron and CitiGroup did the New Power IPO – 27.6 million shares at $21 per share in 10/00. Then, in a deal secretly structured before the IPO, Enron created a phony profit using an LJM2 SPE called Hawaii 125-0. Enron's banks, including CitiGroup, made a "loan" of $125 million to Hawaii 125-0, ***but secretly received a "total return swap" guarantee to protect them against any loss from Enron***. Enron transferred millions of New Power warrants to Hawaii 125-0 to "secure" the banks' loan and thus created a huge $370 million "profit" on the purported gain on the New Power warrants. Hawaii 125-0 simultaneously supposedly "hedged" the warrants with another entity created and controlled by Enron called "Porcupine." To supposedly capitalize Porcupine, LJM2 put $30 million into Porcupine to facilitate the so-called hedge of the New Power warrants, but, one week later, Porcupine paid the $30 million back to LJM2 plus a $9.5 million profit – leaving Porcupine with no assets. New Power stock immediately fell sharply, as the chart below shows:



This collapse converted Enron's huge gain on its New Power equity holdings into a huge loss early in 01 – a loss of about $250 million – which was concealed. ¶42.

G. Hidden/Disguised Loans

Another tactic utilized by Enron and its banks to falsify Enron's financial condition and hide debt involved manipulative transactions with CitiGroup. CitiGroup engaged in a huge subterfuge to disguise large loans to Enron. CitiGroup lent Enron $2.4 billion via "pre-paid" swaps – the so-called "Delta" transactions – conducted through CitiGroup's Cayman Island subsidiary. These swap transactions perfectly replicated loans and were, in fact, loans – but Enron never reported them as such on its balance sheet. ¶45.[15]

By so doing, CitiGroup was able to ***secretly*** prop up Enron's deteriorating finances without disclosing that in fact Enron ***had borrowed billions of dollars from CitiGroup***. Also astonishing about the Delta transaction is the way CitiGroup was "***paid off***" to engage in this manipulative subterfuge. Based on Enron's purported investment grade credit rating, Enron could have borrowed money from banks at 3.75%-4.25%. However, in the phony Delta transaction, ***Enron paid CitiGroup between 6.5%-7.0% for the disguised loans – a huge difference from the cost of a legitimate bank loan – which made these disguised loans hugely profitable for CitiGroup*** – in effect paying CitiGroup off at the rate of $70 million per year for participating in these bogus transactions. ¶46.

H. Enron's Access to the Capital Markets

Enron required constant access to huge amounts of capital. For Enron to continue to appear to succeed it had to keep its investment grade credit rating and keep its stock price high. Enron's investment grade credit rating and high stock price could ***only*** be maintained by (i) limiting the amount of debt shown on Enron's balance sheet; (ii) reporting strong current period earnings; ***and*** (iii) forecasting strong future revenue and earnings growth. Yet Enron was able to achieve these ends only by pursuing an increasing number of phony transactions, many of which were accomplished by increasing the number and size of transaction entities which were supposedly independent of Enron but which, in fact, Enron controlled through a series of secret understandings

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[15] CitiGroup also took unusual steps to protect itself financially against loss from these loans and what they knew were not only dubious but highly dangerous transactions. CitiGroup undertook to lay off substantial portions of its economic risk by selling Enron-linked securities as notes, including the concealed Delta loans in a package of securities. ¶47.

and illicit financing arrangements, including the Chewco, LJM1 and LJM2 partnerships. As a result of reporting strong earnings, the apparent success of its business and its future earnings growth forecasts, Enron had unlimited access to the capital markets, borrowing billions of dollars in the commercial paper markets and by selling billions of dollars of Enron securities to the public. Enron and its bankers raised over $6 billion in new debt and equity capital from public investors for Enron or associated entities through numerous securities offerings, thus raising the capital necessary to allow Enron to repay or pay down its short-term debt and continue to operate. The Enron offerings involving CitiGroup are shown below (¶48):

ENRON SECURITIES UNDERWRITINGS		
Banks Named As Defendants	**Date of Offering**	**Security Sold**
Merrill Lynch ***CitiGroup***	11/96	8 million shares Enron Capital Trust I 8.3% Trust Originated Preferred Securities at $25 per share
Lehman Brothers ***CitiGroup***	08/97	$150,000,000 6.5% Notes due 8/1/2002
Merrill Lynch ***CitiGroup***	1/97	6 million shares Enron Capital Trust II 8-1/8% Trust Originated Preferred Securities at $25 per share
CitiGroup	11/97	$300,000,000 6.45% Notes due 2001
Merrill Lynch ***CitiGroup***	09/98	$250,000,000 Floating-rate Notes due 3/30/2000
CS First Boston Lehman Brothers Merrill Lynch ***CitiGroup***	02/99	27.6 million shares of common stock at $31.34 raising $870 million for Enron
Bank America ***CitiGroup***	08/10/99	$222,500,000 7% Exchangeable Notes due 7/31/2002
Deutsche Bank JP Morgan Bank America Barclays ***CitiGroup***	02/01 (private placement) 7/01 (resales)	$1,907,698,000 Zero Coupon Convertible Senior Notes due 2021, original issue date 2/7/2001

Some of the offerings of Enron associated entities involving CitiGroup are shown below (¶49):

ENRON-RELATED SECURITIES UNDERWRITINGS		
Banks Named As Defendants	**Date of Offering**	**Security Sold**
CS First Boston ***CitiGroup*** CIBC	10/00	27.6 million shares New Power at $21 per share enabling Enron to book a $370 million phony profit
CitiGroup Barclays	2/00	$240,000,000 8.75% Yosemite Enron-linked securities

I. Late 00/Early 01 Prop-Up

In late 00/early 01, Enron's financial results began to come under scrutiny from a few accounting sleuths and short-sellers, who began to question the quality of Enron's reported financial results. While Enron, its top insiders and its bankers – including CitiGroup – assured investors of the correctness of Enron's accounting and the high quality of Enron's reported earnings, the success and strength of its business and its solid prospects for continued strong profit growth, in part because of this increasing controversy, Enron's stock began to decline. As this price decline accelerated, it put pressure on Enron's top executives to do something – anything – to halt the decline in the price of the stock as they knew that if that price decline continued and the stock fell to lower levels, more and more of the Enron stock "triggers" contained in agreements for deals with entities controlled by LJM2 would be triggered, ***which would require Enron to issue over 100 million shares of its common stock to those partnerships, causing a huge reduction in Enron's shareholders' equity.*** ¶52.

In late 3/01, inside Enron it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect a shortfall in credit capacity of the LJM2-financed Raptor SPEs, which would have been catastrophic and exposed the scheme. Rather than take that loss and face these consequences, Enron "restructured" the LJM2-financed Raptor vehicles by transferring ***more than $800 million of contracts to receive Enron's own stock to them just before quarter-end, which permitted the participants in the scheme to conceal substantial losses in Enron's merchant investments, keep billions of dollars of debt off Enron's balance sheet and allowed the Enron Ponzi scheme to continue.*** ¶53.

During early 01, Enron continued to report record results and it and its bankers – ***including CitiGroup*** – continued to make very positive statements (¶54):

- Enron's strong results reflected breakout performance in all business units. Enron was a strong unified business.
- WEOS had strong growth and a tremendous market franchise with significant sustainable competitive advantages.
- EBS intermediation was great. Broadband glut and lowered prices ***would help Enron***.
- VOD was successfully tested and launched. Proven technology created enormous opportunities.
- All of Enron's businesses were generating high levels of earnings. Fundamentals were improving. Enron was very optimistic. Enron was confident growth was sustainable for years to come.

J. The Impending Collapse

By the Summer of 01, Enron's top insiders realized that Enron would not be able to continue to sustain the illusion of strong profitable growth much longer and that it would have to take large write-offs in the second half of 01 that, in turn, could result in a downgrade of Enron's critical investment grade credit rating – an event that they knew would mean that debt on the books of the SPEs Enron did business with (and partnerships controlled by them), which debt Enron had assured investors was "***non-recourse***" to Enron would, in fact, become Enron's obligation. ¶55.

On 8/14/01, Enron announced that Skilling – who had become Enron's CEO just months earlier – was resigning, for "***personal reasons***." While this resignation fanned the controversy over the true nature of Enron's finances and the condition of Enron's business, Enron and its banks – including CitiGroup – lied to investors, telling them that Skilling's resignation was only for personal reasons and did not raise "***any accounting or business issues of any kind***" and that Enron's financial condition "***had never been stronger***" and its "***future had never been brighter***." They said there was "***nothing to disclose***," Enron's "***numbers look good***," there were "***no problems***" or "***accounting issues***." According to them, the Enron "***machine was in top shape and continues to roll on – Enron's the best of the best***." ¶57.

K. The End

By 8/01, inside Enron management employees were complaining to Enron's Board that the fraud at Enron was so widespread it was out of control. In 8/01, two employees complained to the Board (¶59):

A. One employee wrote:

> Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting – most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.
>
> * * *
>
> We have recognized over $550 million of fair value gains on stock via our swaps with Raptor, much of that stock has declined significantly – Avici by 98%, from $178 mm to $5 mm. The New Power Co. by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.
>
> ***I am incredibly nervous that we will implode in a wave of accounting scandals.... [T]he business world will consider the past successes as nothing but an elaborate accounting hoax....***
>
> ***[W]e booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at $38 or worse.*** We are under too much scrutiny and there are probably one or two disgruntled "redeployed" employees who know enough about the "funny" accounting to get us in trouble.
>
> * * *
>
> I realize that we have had a lot of smart people looking at this .... ***None of that will protect Enron if these transactions are ever disclosed in the bright light of day....***
>
> * * *
>
> I firmly believe that the probability of discovery significantly increased with Skilling's shocking departure. Too many people are looking for a smoking gun.
>
> * * *

3. ***There is a veil of secrecy around LJM and Raptor. Employees question our accounting propriety consistently and constantly....***

   a. Jeff McMahon was highly vexed over the inherent conflicts of LJM. ***He complained mightily to Jeff Skilling*** .... 3 days later, Skilling offered him the CEO spot at Enron Industrial Markets ....

b. ***Cliff Baxter complained mightily to Skilling and all who would listen about the inappropriateness of our transactions with LJM.***

c. I have heard one manager level employee ... say "***I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company."... Many similar comments are made when you ask about these deals***....

B. A second employee wrote:

One can only surmise that the removal of Jeff Skilling was an action taken by the board to correct the wrong doings of the various management teams at Enron. However ... I'm sure the board has only scratched the surface of the impending problems that plague Enron at the moment. (*i.e.*, EES's ... hiding losses/SEC violations ... lack of product, etc.).

* * *

[I]t became obvious that EES had been doing deals for 2 years and was losing money on almost all the deals they had booked. (JC Penney being a $60MM loss alone, then Safeway, Albertson's, GAP, etc.). Some customers threatened to sue if EES didn't close the deal with a loss (Simon Properties – $8MM loss day one).... Overnight the product offerings evaporated.... Starwood is also mad since EES has not invested the $45MM in equipment under the agreement.... Now you will loose [sic] at least $45MM on the deal.... You should also check on the Safeway contract, Albertson's, IBM and the California contracts that are being negotiated.... It will add up to over $500MM that EES is losing and trying to hide in Wholesale. Rumor on the 7th floor is that it is closer to $1 Billion....

This is when they decided to merge the EES risk group with Wholesale to hide the $500MM in losses that EES was experiencing. But somehow EES, to everyone's amazement, reported earnings for the 2nd quarter. According to FAS 131 – Statement of Financial Accounting Standards (SFAS) #131, "Disclosures about Segments of an Enterprise and related information," EES has knowingly misrepresented EES' earnings. This is common knowledge among all the EES employees, and is actually joked about....

There are numerous operational problems with all the accounts.

* * *

... Some would say the house of cards are falling....

You are potentially facing Shareholder lawsuits, Employee lawsuits ... Heat from the Analysts and newspapers. The market has lost all confidence, and its obvious why.

You, the board have a big task at hand. You have to decide the moral, or ethical things to do, to right the wrongs of your various management teams.

* * *

... But all of the problems I have mentioned, they are very much common knowledge to hundreds of EES employees, past and present.

On 10/16/01, Enron shocked the markets with revelations of $1.0 billion in charges and a reduction of shareholders' equity by $1.2 billion. Within days, *The Wall Street Journal* began an exposé of the LJM SPEs, the SEC announced an investigation of Enron and Fastow "resigned." In 11/01 Enron was ***forced to admit that Chewco had never satisfied the SPE accounting rules and – because JEDI's non-consolidation depended on Chewco's status – neither did JEDI, and Enron consolidated Chewco and JEDI retroactive to 97. This retroactive consolidation resulted in a massive reduction in Enron's reported net income and massive increase in its reported debt.*** Enron then revealed that it was restating its 97, 98, 99 and 00 financial results to eliminate $600 million in previously reported profits and approximately $1.2 billion in shareholders' equity as detailed below (¶61):

ENRON ACCOUNTING RESTATEMENTS				
	1997	1998	1999	2000
Recurring Net Income Amount of Overstatement	$ 96,000,000	$113,000,000	$250,000,000	$ 132,000,000
Debt Amount of Understatement	$711,000,000	$561,000,000	$685,000,000	$ 628,000,000
Shareholders' Equity Amount of Overstatement	$313,000,000	$448,000,000	$833,000,000	$1,208,000,000

These partnerships – Chewco, LJM and LJM2 – ***were used by Enron and its banks to enter into transactions that Enron could not, or would not, do with unrelated commercial entities***. The significant transactions were designed ***to create phony profits or to improperly offset losses***. These transactions allowed Enron and its banks to conceal from the market ***very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged – that is, that a third party was obligated to pay Enron the amount of those losses, when in fact that third party was simply an entity in which only Enron had a substantial economic stake. The***

Raptors transactions alone resulted in Enron reporting earnings from the 3rdQ 00 through the 3rdQ 01 that were almost $1 billion higher than should have been reported! ¶62.[16]

Notwithstanding the write-offs and restatement revelations of 10/01-11/01, Enron, JP Morgan and CitiGroup believed that they could limit their legal exposure for participation in the scheme if they could sell Enron to another company. So, in 11/01 as the Enron scheme began to unravel, Enron tried desperately to arrange a salvation merger with Dynegy to avoid insolvency and the inevitable investigations and revelations that would follow. ¶64. However, Dynegy uncovered that the true financial condition of Enron was far worse than had been disclosed publicly and that Enron had been engaged in a wide-ranging falsification of its financial statements over the several prior years. Thus, Dynegy refused to acquire Enron. By 11/28/01 Enron's publicly traded debt had been downgraded to "junk" status, and on 12/2/01, Enron filed for bankruptcy – ***the largest bankruptcy in history***. Enron's common and preferred stock have become virtually worthless and its publicly traded debt securities have suffered massive price declines, inflicting billions of dollars of losses on purchasers of those securities. ¶66.

As *Newsweek* has written (¶69):

> In the late 1990s, by my count, Enron lost about $2 billion on telecom capacity, $2 billion in water investments, $2 billion in a Brazilian utility and $1 billion on a controversial electricity plant in India. Enron's debt was soaring. If these harsh truths became obvious to outsiders, Enron's stock price would get clobbered – and a rising stock price was the company's be-all and end-all. Worse, what few people knew was that Enron had engaged in billions of dollars of off-balance-sheet deals that would come back to haunt the company if its stock price fell.

Newsweek, 1/21/02.

> ***The key to the Enron mess is that the company was allowed to give misleading financial information to the world for years***. Those fictional figures, showing nicely rising profits, enabled Enron to become the nation's seventh largest company, with $100 billion of annual revenues. Once accurate numbers started coming out in October, thanks to pressure from stockholders, lenders and the previously quiescent SEC, Enron was bankrupt in six weeks. The bottom line: we have to change the rules to make companies deathly afraid of producing dishonest numbers, and we have to make accountants mortally afraid of certifying them. Anything else is window dressing.

Newsweek, 1/28/02. The rise and demise of Enron is graphically presented below:

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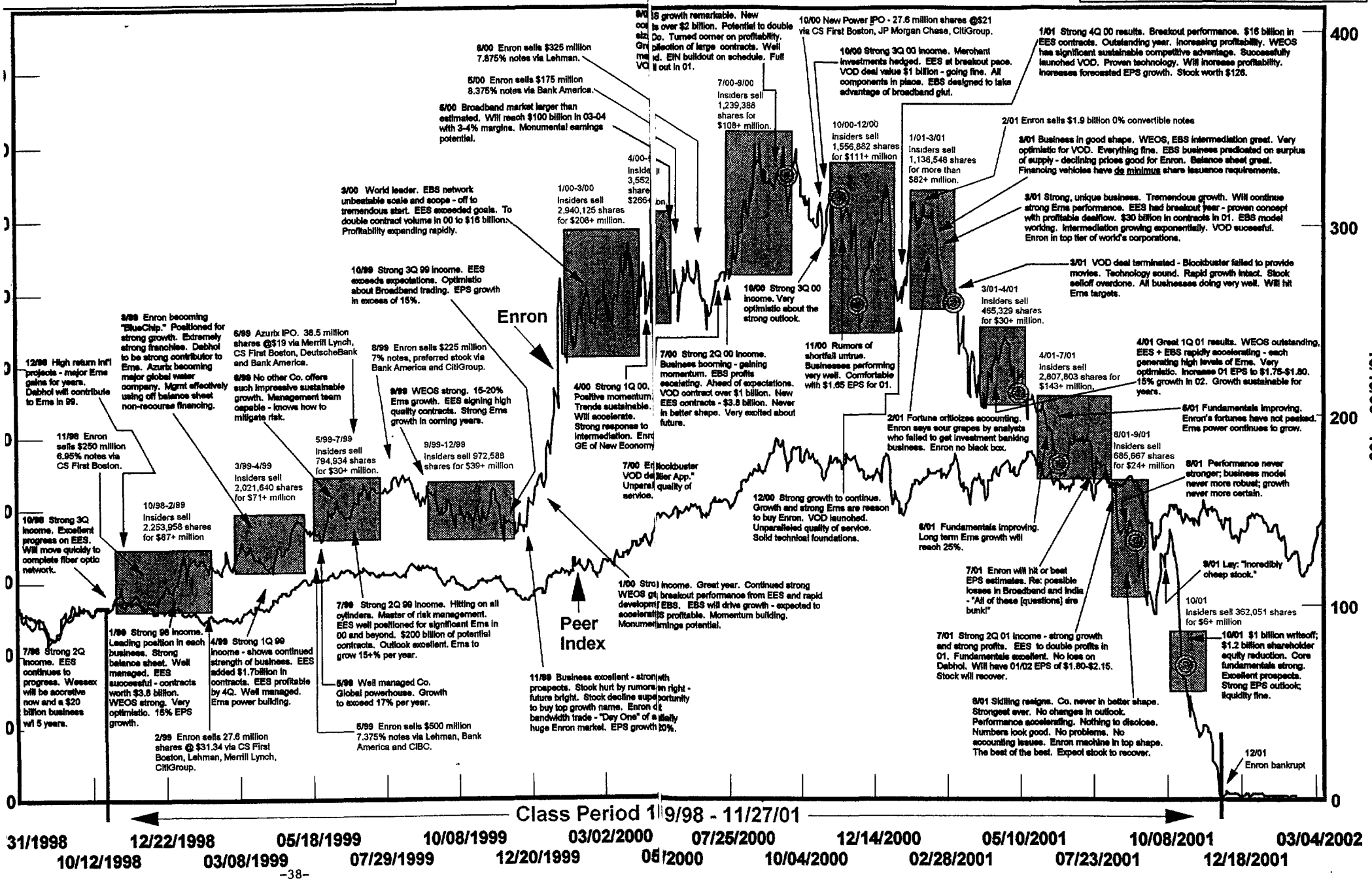
[16] As huge as the 11/01 restatements of Enron's 97-00 financial statements were, they just scratched the surface of the true extent of the prior falsification of Enron's financial statements. ¶63.

Enron Timeline

7/1/98 - 3/7/02

Total Shares Sold By Defendants: 20,788,957 shares
Defendants' Insider Trading Proceeds: $1,190,479,472

Enron Stock Issuance Price Trigger



II. SUMMARY OF CITIGROUP'S INVOLVEMENT AND LIABILITY

CitiGroup's relationships with Enron were very extensive. ***Top officials*** of the bank constantly interacted with top executives of Enron, *i.e.*, Lay, Skilling, Causey, McMahon or Fastow, on an almost daily basis throughout the Class Period, discussing Enron's business, financial condition, financial needs and plans, partnerships, SPEs and future prospects. CitiGroup participated in the fraudulent scheme and course of business in several ways. CitiGroup also helped secretly fund the LJM2 partnership Enron controlled, knowing it was a vehicle being utilized by Enron to falsify its reported financial results, while providing CitiGroup lush returns from the looting of Enron. CitiGroup also engaged in numerous contrived and deceptive transactions with Enron to disguise billions of dollars in loans to Enron, thus helping Enron falsify its true financial condition, liquidity and creditworthiness. ¶675. It also participated in ***disclosed*** commercial loans and lending commitments of over $4 billion to Enron during the Class Period, and helped raise over $3.5 billion from the investing public for Enron via the sale of Enron and Enron-related securities, sales often accomplished via false Registration Statements. ¶675. And all the while, CitiGroup was issuing 18 false and misleading analysts' reports on Enron. ¶686.

CitiGroup made false and misleading statements in an 8/99 Registration Statement to sell $222 million of Enron 7% exchangeable notes,[17] in a 2/99 Registration Statement for the sale of 27.6 million shares of Enron common stock and in a 10/00 Registration Statement for the New Power IPO. CitiGroup also made false and misleading statements in 18 analysts' reports on Enron it issued during the Class Period, which helped to artificially inflate the trading prices of Enron's securities. *See infra* at 95-97. Such false statements are expressly made illegal by the text of Rule 10b-5, issued pursuant to §10(b) of the 1934 Act, which prohibits "***any untrue statement of material fact***" by "***any person***" in connection with securities transactions.

CitiGroup's false statements in the 2/99 Registration Statement for the sale of 27.6 million shares of Enron common stock, in the 8/99 Registration Statement for the sale of Enron's 7% exchangeable notes and in the 10/00 Registration Statement for the New Power IPO, and in its 18

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[17] Plaintiffs concede there is no 1933 Act §11 claim against CitiGroup for their offering.

analysts' reports were also part of a wider pattern of misconduct by CitiGroup in which CitiGroup employed acts, manipulative or deceptive devices and contrivances to deceive and participated in a fraudulent scheme and course of business – disguising and thus concealing billions of dollars of loans to Enron, providing millions to finance Enron's secretly controlled partnerships and illicit transactions with associated SPEs to falsify Enron's reported financial condition and profits, all of which operated to artificially inflate the prices of Enron's publicly traded securities. This conduct is also expressly prohibited by the language of §10(b) and Rule 10b-5.[18] CitiGroup's sale of Enron and Enron-related securities, its loans to Enron and its analysts' reports on Enron are shown on the following graphic chart:

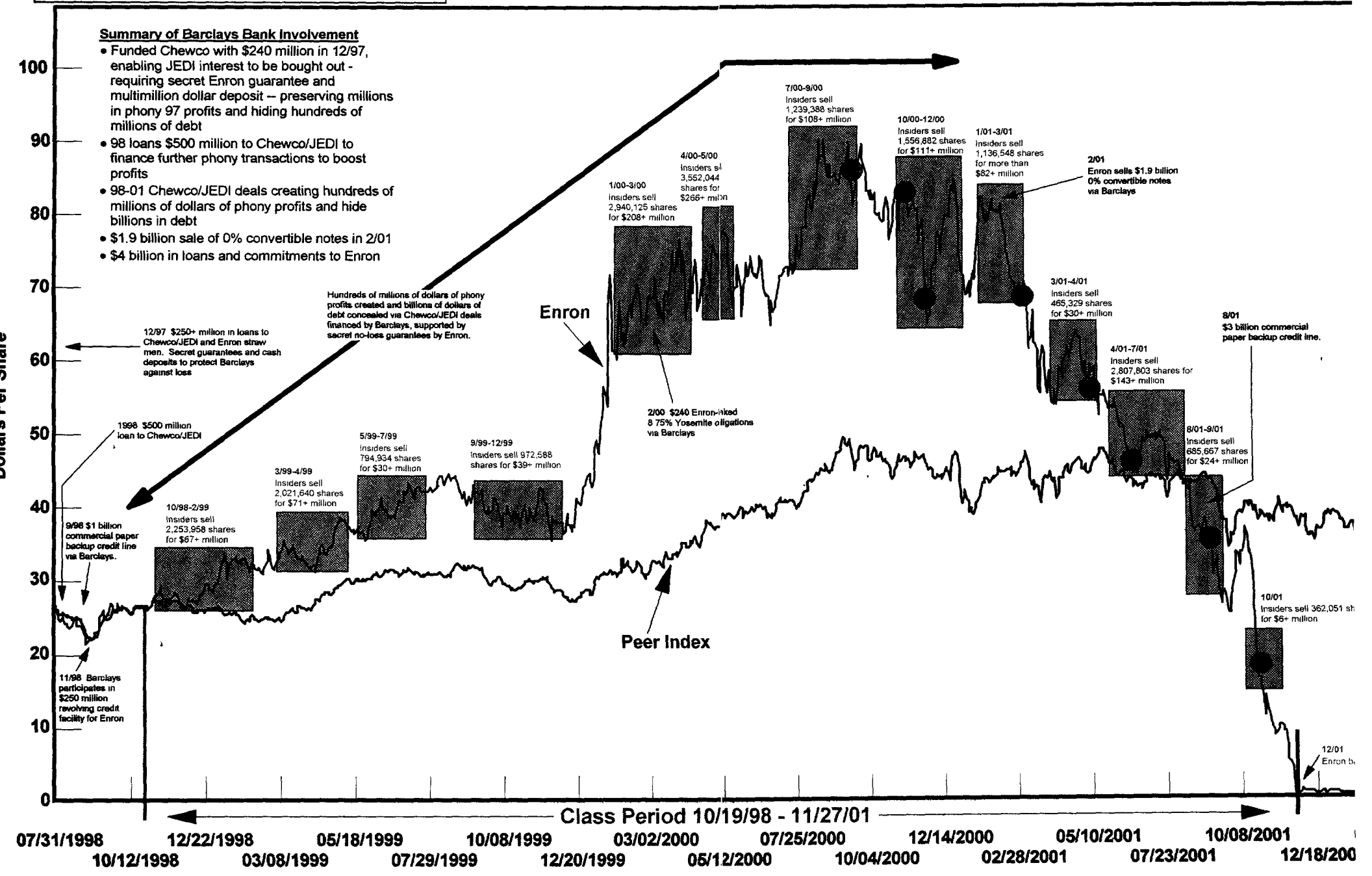
[18] False statements in a Registration Statement can create liability under both 1933 Act §11 and 1934 §10(b), and Rule 10b-5. *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). The remedies provided investors under the 1933 and 1934 Acts are cumulative. *Id.*

Total Shares Sold By Defendants: 20,788,957 shares
Defendants' Insider Trading Proceeds: $1,190,479,472

Enron Timeline -- Barcays Underwritings/Loans/Analyst Reports

7/31/98 - 3/7/02

Bank America Analyst R
Enron Stock Issuance P



According to the Supreme Court, §10(b)'s prohibition of "any ***manipulative or deceptive device or contrivance***" necessarily encompasses any "***scheme to defraud***." In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court referred to the ***dictionary definitions*** of §10(b)'s words, to find that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice.'" *Id.* at 199 n.20 (quoting *Webster's International Dictionary* (2d ed. 1934)). The Court found that a "contrivance" means "'***a scheme, plan, or artifice***.'" *Id.* (quoting *Webster's International Dictionary*); *see also Aaron v. SEC*, 446 U.S. 680, 696 n.13 (1980). Thus, scheme liability ***is authorized by the text of §10(b)***. Rule 10b-5 – adopted by the SEC to implement §10(b) – accordingly, in addition to prohibiting false statements, makes it unlawful for any person "***directly or indirectly***" to employ "***any*** device, ***scheme***, or artifice ***to defraud***" or to "***engage in any act, practice, or course of business which operates ... as a fraud or deceit upon any person***." 17 C.F.R. §240.10b-5. *See also U.S. Quest, Ltd. v. Kimmons*, 228 F.3d 399, 407 (5th Cir. 2000).

In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the Court observed that "the second subparagraph of [Rule 10b-5] specifies the making of an untrue statement of a material fact and the omission to state a material fact," *id.* at 152-53, but held that "[t]he first and third subparagraphs ***are not so restricted***." *Id.* at 153. It held that the defendants violated Rule 10b-5 when they participated in "***a 'course of business' or a 'device, scheme or artifice' that operated as a fraud***" – ***even though these defendants had never themselves said anything that was false or misleading***. *Id.*; *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) ("'[We do not] think it sound to dismiss a complaint merely because the ***alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that §10 (b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws***.'") (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). As stated by the Second Circuit: ***"Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures.'"***

Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975). "Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws." *Id.*

Thus, the Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading Offering Circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that Offering Circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme."*** *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981). *See Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 363 (5th Cir. 1987) (complaint alleging manipulation of reported financial results by two public companies properly alleged a scheme to defraud or course of business operating as a fraud as the effect was to defraud purchasers of Docutel stock in violation of Rule 10b-5(a) and (c)).

The fraudulent scheme and course of business involving Enron ***was worldwide in scope, years in duration and unprecedented in scale***. Wrongdoing of this scope and on this scale could not have been accomplished solely by the efforts of Enron's executives, no matter how dishonest or determined they may have been. Wrongdoing of this scope and on this scale required the skills and active participation of lawyers, bankers and accountants. It could not have happened otherwise.

The notion that *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), issued a broad edict that lawyers, banks and accountants are immune from liability for their participation in complex securities frauds is nonsense. *Central Bank* expressly recognized: "The absence of §10(b) aiding and abetting liability ***does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer ... or bank who employs a manipulative device[19] or makes a material misstatement (or omission)***

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[19] As pointed out earlier, the Court has previously held that §10(b)'s language "any manipulative or deceptive device or contrivance" includes a "scheme to deceive" or "scheme, plan or artifice." *Ernst & Ernst*, 425 U.S. at 199 n.20.

on which a purchaser ... relies[20] ***may be liable as a primary violator under 10b-5.... In any complex securities fraud, moreover, there are likely to be multiple violators.***" *Id.* at 191. A scheme to defraud often will involve a variety of actors, and investors are entitled to allege "***that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme.***" *Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1998); *accord SEC v. First Jersey Sec.*, 101 F.3d 1450, 1471 (2d Cir. 1996).

Central Bank denied recovery to victims of an alleged securities fraud who pleaded ***only one theory of recovery*** against a bank defendant – "secondary" liability they dubbed "aiding and abetting." 511 U.S. at 191. However, neither the words aiding and abetting nor any other language encompassing aiding and abetting appear in §10(b) or Rule 10b-5. The Court said "***the text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation [and] that conclusion resolves the case.***" *Id.* at 177. The *Central Bank* plaintiffs did not, as the plaintiffs here do, plead or pursue recovery under the theory that the bank defendant (i) made false and misleading statements in Registration Statements where the bank acted as underwriter in selling securities or other documents the bank issued to the public, *e.g.*, analysts' reports, ***or*** (ii) employed acts, manipulative or deceptive devices and contrivances, ***or*** (iii) engaged in a fraudulent scheme or course of business that operated as a fraud or deceit on purchasers of the securities in issue. In the words of the Court, the plaintiffs "***concede that Central Bank did not commit a manipulative or deceptive act within the meaning of §10(b).***" *Id.* at 191. Plaintiffs here make no such concession. Thus, because the *Central Bank* plaintiffs made fatal concessions and pursued a theory of recovery which found ***no support in the text of either the statute or the rule, they lost.***

Central Bank cannot mean that a defendant cannot be liable under §10(b) unless the defendant made misleading statements because the Court later rejected that argument in *United States v. O'Hagan*, 521 U.S. 642 (1997). The Eighth Circuit had held that, under *Central Bank*,

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[20] Because this action's 1934 Act claims are "fraud-on-the-market" claims, reliance is established, *i.e.*, presumed, based on the materiality of false representations to the market, subject to defendants' right to rebut that presumption. *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988); *Summit Props. v. Hoechst Celanese Corp.*, 214 F.3d 556, 561 (5th Cir. 2000), *cert. denied*, 531 U.S. 1132 (2001); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 298 (5th Cir. 1990).

"§10(b) covers ***only deceptive statements or omissions on which purchasers and sellers ... rely.***" *Id.* at 664. The Court reversed, holding that §10(b) does not require a defendant to speak because §10(b) prohibits "***any manipulative or deceptive device or contrivance***" in contravention of SEC rules and thus reaches "any deceptive device," whether or not the defendant spoke. *Id.* at 671. *Superintendent of Ins.*, 404 U.S. 6, is consistent with *O'Hagan*. In *Superintendent of Ins.*, a ***unanimous*** Court upheld a §10(b)/Rule10b-5 complaint involving a "fraudulent scheme" involving the sale of securities where ***no*** false statement was alleged because:

> ***There certainly was an "act" or "practice" within the meaning of Rule 10b-5 which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds.***

Id. at 9 (footnote omitted).

This Court has repeatedly stated:

> ***A defendant need not have made a false or misleading statement to be liable.***

Landry's, slip op. at 9 n.12; *In re Waste Mgmt., Inc. Sec. Litig.*, No. H-99-2183, slip op. at 75 (S.D. Tex. Aug. 16, 2001);[21] *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 869 (S.D. Tex. 2001). ***Thus, while false statements are not required for §10(b)/Rule 10b-5 liability, here CitiGroup allegedly made numerous false statements about Enron in Registration Statements and analysts' reports.***

That this reading of §10(b)/Rule 10b-5 is clearly correct is shown by a new ***unanimous*** Supreme Court decision – *SEC v. Zandford*, __ U.S. __, No. 01-147, 2002 U.S. LEXIS 4023 (June 3, 2002). In *Zandford*, the Court repeatedly cited with approval its seminal "***fraudulent scheme***" case *Superintendent of Ins.*, and reversed dismissal of a §10(b)/Rule 10b-5 complaint making the following key points:

- "***The scope of Rule 10b-5 is coextensive with the coverage of §10(b)*** ...." *Id.* at *7 n.1.

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[21] Due to the length of the opinions in *Landry's* and *Waste Management*, and the fact that they Court has access to them, they have not been attached to this brief.

- ***"[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b).*** *Id.* at *13.[22]

- Allegations that defendant "***'engaged in a fraudulent scheme'***" or "***'course of business that operated as a fraud or deceit'***" stated a §10(b) claim. *Id.* at *13, *14-*17.

Central Bank clearly – ***but merely*** – stands for the proposition that no aiding and abetting liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain language encompassing "aiding and abetting." The decision in *Central Bank* is actually ***quite narrow***. By contrast, the language of §10(b) and Rule 10b-5 is ***very broad*** and the purposes of §10(b) and Rule 10b-5 are remedial, intended to provide access to federal court to persons victimized in fraudulent securities transactions:

> [T]he 1934 Act and its companion legislative enactments [including the 1933 Act] embrace a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry ...."Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Affiliated Ute Citizens, 406 U.S. at 151. As noted by the Fifth Circuit:

> [T]he Court has concluded that the Exchange Act and the Securities Act should be ***construed broadly to effectuate the statutory policy affording extensive protection to the investing public***. *See Tcherepnin*, 389 U.S. at 336, 88 S. Ct. at 553. *See also* S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) (***indicating legislative intent of the Securities Act to protect the public from the sale of fraudulent and speculative schemes***).

Meason v. Bank of Miami, 652 F.2d 542, 549 (5th Cir. 1981). "***The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively.***" *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980).

Here, CitiGroup did it all. CitiGroup made false statements in three Registration Statements where CitiGroup acted as underwriter to sell Enron and Enron-related securities and in 18 analysts' reports on Enron. And CitiGroup employed specified acts, manipulative or deceptive devices and contrivances to help falsify Enron's finances and which were essential to the ongoing fraudulent scheme and course of business. In short, in order to pocket billions of dollars of fees, commissions,

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[22] To the extent *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001), seems to require a statement be made about a company which is "publicly attributable to the defendant at the time the plaintiff's investment decision was made," it is inconsistent with *Zandford*.

interest and other charges – profits from its investment in the fraudulent scheme and course of business – CitiGroup facilitated, furthered and participated in the fraud. All of these activities directly contravened prohibitions of the 1933 and 1934 Acts. CitiGroup was not an unwitting victim of the fraud involving Enron – ***it was an active perpetrator of and participant in that fraud. Thus, CitiGroup's alleged liability is "primary"*** and not "***secondary***."

Not only does the CC assert viable legal theories of recovery against CitiGroup under the 1933 and 1934 Acts, it also pleads ***in detail*** why the statements made by CitiGroup were false when made and why CitiGroup ***knew or recklessly disregarded that those statements were false***, thus satisfying the two-pronged pleading standard, *i.e.*, "falsity" and "scienter" of the 95 Act as applicable to the 1934 Act. 15 U.S.C. §78u-4.

The Registration Statements CitiGroup used to sell 27.6 million shares of Enron common stock in 2/99, $222 million in 7% Enron exchangeable notes in 8/99 and 27.6 million shares of New Power stock in 10/00 contained Enron's false annual and interim financial results and false statements concerning the structures of and Enron's relationship to SPEs and related parties, Enron's financial risk management statistics, as well as the condition of Enron's business operations and the value of its assets. *See infra* at 95-96. The 18 CitiGroup analysts' reports on Enron issued between 10/98-10/01 also contained false statements about Enron's financial results and financial condition and the success of Enron's EES and EBS businesses. *See infra* at 74-94. Thus, the allegedly false statements made by CitiGroup are ***quoted, specified by date, and the reasons the statements were false when made are pleaded***, satisfying the 95 Act's "falsity" pleading requirement. *See id.*

CitiGroup's scienter, *i.e.*, its "required state of mind" is also well-pleaded.[23] The CC explains how, due to the close involvement of CitiGroup top executives and commercial and investment bankers with Enron, in lending, deal-making and other activities, CitiGroup knew of the falsity of the statements it was making in Registration Statements and analysts' reports concerning Enron. ¶¶674-692. The CC also details numerous specific fraudulent Enron transactions involving CitiGroup which were intentionally deceptive acts or contrivances to deceive – falsifying Enron's

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[23] Scienter is only required for the 1934 Act claims. CitiGroup's 1933 Act liability requires no showing of fraud, intent or knowledge. 15 U.S.C. §77k; *Landry's*, slip op. at 11 n.13, 65.

publicly reported financial results and financial condition and making Enron's business appear to be successful when it was not. These include:

- The phony Delta swaps by which CitiGroup enabled Enron to artificially manipulate and boost its revenues and disguise some $2.4 billion in loans to Enron, while charging extraordinarily high, excessive and hugely profitable interest rates to compensate CitiGroup for engaging in these dangerous, bogus transactions. ¶¶45-47.

- Helping to "pre-fund" Enron's LJM2 partnership in the last days of 12/99 with $1.5 million advanced by CitiGroup, which enabled LJM2 to fund four critical non-arm's-length fraudulent year-end 99 deals with Enron to inflate Enron's 99 results – generating false profits and hiding hundreds of millions of dollars of debt. ¶¶26-29, 881-882.

- During 00-01, CitiGroup invested $15 million in LJM2, as CitiGroup actually administered LJM2's ongoing financial affairs while LJM2 participated in billions of dollars worth of non-arm's-length fraudulent transactions with Enron to boost its profits and hide billions of dollars of debt that should have been reported on Enron's balance sheet while allowing CitiGroup to pocket its share of the lush profits on these LJM2 deals flowing from the looting of Enron. ¶687.

- Participating in the New Power IPO in 10/00 via which Enron improperly created a $370 million bogus profit via a non-arm's-length transaction with LJM2. ¶679.

In addition to CitiGroup's knowledge of the fraud and intentional involvement in many of Enron's deceptive and fraudulent transactions, the CC details CitiGroup's motive and opportunity[24] to engage and participate in the fraudulent scheme and course of business. CitiGroup was reaping huge amounts of money from the scheme due to interest and commitment fees on its commercial lending transactions with Enron. Also, CitiGroup ***was being rewarded by being allowed to get in on LJM2 and thus was reaping huge returns as secret investors in the LJM2 partnership, unusually profitable returns generated by that entity's illicit deals with Enron SPEs[25] – transactions CitiGroup knew would collapse if Enron's stock fell through the equity issuance trigger prices embedded in those LJM2/SPE deals***. CitiGroup was also profiting from its

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[24] By selling Enron and Enron-related securities via SEC filed Registration Statements and issuing analysts' reports on Enron and helping structure and finance Enron's illicit partnerships and their related SPE transactions, CitiGroup had plenty of opportunity to mislead investors and advance the fraud as well.

[25] The returns to the LJM2 investors were huge – up to 2,500% on one deal and 51% overall ***in the first year*** of the partnership. ***Skilling has recently told investigators such gargantuan returns were possible only because LJM2, with Fastow at the wheel, was defrauding Enron in the billions of dollars of deals it was doing with Enron so Enron could create false profits and hide billions of dollars in debt***. Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicion of Fraud," *New York Times*, 4/24/02.

participation in the fraudulent scheme by charging Enron grossly excessive rates for secretly arranging billions of dollars of disguised loans via its Delta subsidiary – ***some 3% over normal rates on concealed loans of some $2.4 billion*** – *i.e.*, a $70 million per year ***payoff***. CitiGroup had ***powerful incentives for CitiGroup to take steps to not only keep Enron solvent, but to maintain its coveted investment grade credit rating*** which provided Enron access to the commercial paper market. CitiGroup had made and was making hundreds of millions of dollars from the fraudulent scheme involving Enron and Enron's fraudulent course of business and stood to continue to make hundreds of millions more ***if it could be sustained – and to lose a bundle if the scheme was discovered, unraveled or came to an end***. CitiGroup had plenty of motive to defraud Enron's investors.

Thus, as to CitiGroup, the CC pleads 1933 Act §11 non-fraud liability and 1934 Act ***"primary liability" based on legal theories*** of recovery rooted in the express language of §10(b) and Rule 10b-5 and pleads the facts in ***sufficient detail*** to satisfy the "falsity" and "scienter" prongs of the 95 Act's pleading standard applicable to the 1934 Act.

And, in fact, many courts have upheld complaints against banks in §10(b)/Rule 10b-5 cases where, as here, false statements, manipulative or deceptive devices, contrivances and acts, and participation in a scheme to defraud have been alleged with sufficient particularity. *Cooper*, 137 F.3d at 628 (Scheme liability survived *Central Bank*. Allegations that the investment bank defendants had issued analysts' reports knowing them to be false due to their "***access to inside information***" stated a valid §10(b)/Rule 10b-5 claim.); *In re Livent, Inc. Noteholders Sec. Litig.*, 174 F. Supp. 2d 144, 150-52 (S.D.N.Y. 2001) (complaint alleging investment bank made disguised loan to Livent enabling Livent to falsify financial condition, while selling securities to public states valid §10(b)/Rule 10b-5 claims); *Murphy v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1996 U.S. Dist. LEXIS 22207 (D. Or. May 9, 1996) and *Flecker v. Hollywood Entm't Corp.*, No. 95-1926-MA, 1997 U.S. Dist. LEXIS 5329, at *25 (D. Or. Feb. 12, 1997) (Refused to dismiss a complaint or grant summary judgment to banks, stating that their "***roles as analysts, investment bankers and business advisors with extensive contacts with [issuer] defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a***

triable primary liability claim under §10(b)."); *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558, 1568 (S.D. Fla. 1993) (allegations that a securities broker issued false reports on company which made exaggerated predictions while ignoring "red flags" adequately pleaded recklessness); *McNamara v. Bre-X-Minerals Ltd.*, No. 5:97-CV-159, 2001 U.S. Dist. LEXIS 4571, at *166 (E.D. Tex. Mar. 30, 2001) (Denied motion to dismiss by J.P. Morgan based on allegations it participated in a scheme to violate §10(b)/Rule 10b-5 by helping to structure fraudulent business transactions, acting as financial advisor and issued false analysts' reports, while ignoring "red flags."). *See also SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 112 (2d Cir. 1998) (while there is no aiding and abetting, where complaint properly alleged defendant to be primary violator because he "***participated in the fraudulent scheme***," noting "***lawyers, accountants, and banks who engage in fraudulent or deceptive*** practices at their client's direction [are] a primary violator"); *Scholnick v. Continental Bank*, 752 F. Supp. 1317, 1323 & n.9 (E.D. Mich. 1990) ("bank ... may still be held liable under Rule 10b-5(a) and 10b-5(c) as a participant in the allegedly fraudulent scheme" and "allegations that Continental was directly involved in perpetrating a fraudulent scheme distinguish" case from situation where bank was only engaging in a "routine commercial financing transaction"). The CC in this action pleads more wrongful conduct by CitiGroup vis-à-vis the fraudulent scheme involving Enron and with greater specificity than was pleaded in any of the above cases where complaints naming banks as defendants in §10(b)/Rule 10b-5 actions were upheld.

Of course, as with most fraudulent schemes, the scheme to falsify Enron's finances and inflate the prices of its securities – and sustain its fraudulent course of business – ultimately collapsed from the accumulated weight of years of deceit and deception. But the fact that the scheme ultimately collapsed in late 01 is of little legal moment. It had succeeded for years, enriching the perpetrators to the tune of billions of dollars. Securities violators frequently find themselves involved in complicated schemes by which financial reports are manipulated, securities prices are inflated, new securities are sold to the public and yet, despite all their efforts to perpetuate the wrongdoing, the scheme ultimately collapses and their participation is disclosed. But participants in fraudulent schemes – especially Ponzi securities schemes like Enron – expect them to succeed and take action to help them ***continue to succeed, as they gain more profits from the scheme as long as it***

continues. The fact that such complex schemes may ultimately fail – and the perpetrators may ***then*** suffer some loss – in no way shields them from liability for the damage inflicted on the victims of their unlawful conduct while the scheme was succeeding. In the end it is the public investors in a situation like Enron – the people and pension funds who invested ***billions of dollars to purchase Enron securities at inflated prices that are left holding the bag. They are the ones who are truly damaged***. And the federal securities laws are supposed to protect them.

The important remedial purposes of investor suits under the anti-fraud provisions of the 1934 Act were ***ratified by Congress when it enacted the 95 Act***:

> The overriding purpose of our Nation's securities laws is to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans.
>
> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that ***corporate officers, auditors, directors, lawyers and others properly perform their jobs***.

H.R. Conf. Rep. No. 104-369, at 731 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 730. The 95 Act's pleading requirements must be applied and interpreted with these important principles in mind.

It is an unfortunate reality that the worst securities frauds create the most difficult situations for the victims.[26] The issuer (here Enron) goes bankrupt – and is ***shielded from liability***. Whatever directors' and officers' liability insurance policies exist (here some $350 million) ***are impaired*** – as the carriers can claim that they were defrauded into issuing the policies by the issuer's false financial statements. Here, the situation is further exacerbated by the fact that Andersen, which played a significant role in the fraud, is financially impecunious and able to pay only a fraction of the damages suffered by the victims.

If Enron investors are to achieve any significant recovery here, in what is acknowledged to be the largest and worst financial fraud in U.S. history, it will only be because our nation's securities laws permit these victims to hold accountable ***securities professionals like banks and lawyers, who are supposed to safeguard the public in securities transactions, for their misconduct in employing***

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[26] For instance, *Equity Funding*, *U.S. Financial*, *Lincoln Savings*, *Washington Public Power Supply Systems* and *Global Crossing*.

acts and contrivances to deceive and participating in a scheme to defraud and a course of business that operated as a fraud or deceit on those purchasers of Enron's securities. One man's deep pocket is another's legitimate defendant. If our Nation's securities laws do not provide an opportunity for the thousands of investors in Enron – what appeared to be a hugely successful public company earning a billion dollars of profit a year – to pursue Enron's bankers and lawyers who allegedly engaged and participated in the fraudulent scheme and course of business, that will make a mockery of the investor protection purposes of our securities laws. To put it bluntly, if the 95 Act's enhanced pleading standard combined with the Court's decision in *Central Bank* operate to shield the banks named as defendants here from even having to answer the CC and defend the allegations on the merits, then Congress will have to act by ameliorating that harsh pleading standard and restoring aiding and abetting liability.

III. DETAILED FACTUAL ALLEGATIONS REGARDING CITIGROUP

> In reviewing the sufficiency of a complaint in response to a motion to dismiss for failure to state a claim under Fed. R. Civ. P. 12(b)(6), before any evidence has been submitted, the district court's task is limited. *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support its claims. *Id.* The district court should consider all allegations in favor of the plaintiff and accept as true all well-pleaded facts in the complaint. *Lawal v. British Airways, PLC*, 812 F. Supp. 713, 716 (S.D. Tex. 1992). Dismissal is not appropriate "unless it appears beyond a doubt that the plaintiff can prove no set of facts in support of [his] claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

Landry's, slip op. at 4 n.8. The Fifth Circuit recently stated, "we will accept the facts alleged in the complaint as true and construe the allegations in the light most favorable to the plaintiffs." *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 406 (5th Cir. 2001). This Court must consider the allegations in their entirety. As Judge Buchmeyer stated in *STI Classic Fund v. Bollinger Indus., Inc.*, No. 3-96-CV-823-R, 1996 U.S. Dist. LEXIS 21553, at *5 (N.D. Tex. Oct. 25, 1996), it is improper to isolate "the circumstances alleged in Plaintiffs' amended complaint rather than to consider them in their totality."[27]

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[27] CitiGroup makes the point that the 500-page CC uses the word "help" or "helped" to describe its conduct vis-à-vis Enron on some occasions. Seizing on the word help/helped, CitiGroup claims that its use conclusively shows that the true core allegation against it here is one of aiding and abetting, which is barred by *Central Bank*. This argument is wrong. First of all, persons who participate in a scheme to defraud or a course of business that operates as a fraud or deceit on

CitiGroup seems to argue that the three-year statute of response for 1934 Act claims bars plaintiffs from pursuing damages against it for any time period prior to 4/8/99 ***and*** any consideration of its alleged misconduct prior to 4/8/99 for pleading or other purposes. We agree as to the former point, but not as to the latter. In other words, while the three-year statute of repose bars damage recovery from CitiGroup on behalf of purchasers who purchased before 4/8/99, it does not affect plaintiffs' ability to plead conduct or present evidence of its misconduct prior to that date. *United States v. Ashdown*, 509 F.2d 793 (5th Cir. 1975), affirmed defendants' mail fraud convictions, holding there was no merit in the argument that it was error to admit evidence of acts committed beyond the statute of limitations period where the evidence helped to establish the scheme – "the statute of limitations is a defense to prosecution, not a rule of evidence. Therefore, once prosecution is timely instituted, the statute of limitations has no bearing on the admissibility of evidence." *Id.* at 798.[28] Instead, the court found that the evidence defendants questioned "***helps establish the scheme and the guilty intent.***" *Id.*; *accord United States v. Blosser*, 440 F.2d 697, 699 (10th Cir. 1971) (Evidence of mail fraud occurring before the statute of limitations "***bore on the existence of the scheme to defraud, the falsity of representations made, and intent.***").[29]

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purchasers of a public company's securities or employ acts or manipulative or deceptive devices are actually "helping" to defraud investors. In any event, this is not medieval England where meritorious actions are dismissed because pleaders used an ambiguous word or mischaracterized a claim for relief. Fortunately, in the United States today, complaints are to be construed ***in favor of the pleader with all ambiguities resolved and inferences drawn in the pleader's favor***. And the CC clearly does repeatedly allege that CitiGroup participated in a fraudulent scheme or course of business while employing acts and/or contrivances to deceive. That conduct is actionable under the text of §10(b) and Rule 10b-5 as well as the wealth of decisions cited in this brief.

[28] There is no dispute that as to CitiGroup, claims were timely filed for the three-year period, beginning 4/8/99.

[29] An early case upholding this principle is *Little v. United States*, 73 F.2d 861 (10th Cir. 1934). There, the court held that "if the mails were used in execution of a fraudulent scheme, it is no defense that the scheme was formed and partially carried out back of the statute of limitations. Proof running back of the statute is admissible provided it is connected up with the scheme existing when the letters were mailed." *Id.* at 867; *accord United States v. Marconi*, 899 F. Supp. 458, 463 (C.D. Cal. 1995) (Defendant misunderstood the nature of the statute of limitations as "acts of fraud prior to that date are still evidence of his continuing fraudulent scheme to defraud." Trier of fact can consider defendant's pre-statute of limitations action to determine whether defendant had the requisite intent to defraud.); *United States v. Whitt*, 718 F.2d 1494, 1501 (10th Cir. 1983) (Certain testimony regarding events that were not within the statute of limitations was used "to establish a scheme or plan rather than as direct evidence."); *United States v. Haskins*, 737 F.2d 844, 848 (10th Cir. 1984) (Affirmed mail fraud and extortion convictions noting that arguments relating to evidence of

A similar result has been obtained in Title VII cases. *Fitzgerald v. Henderson*, 251 F.3d 345 (2d Cir. 2001), *petition for cert. filed*, (Aug. 29, 2001), held that evidence of defendant's sexual advances and the fact that the plaintiff rebuffed those advances at an earlier time were relevant to show defendant's motivation for the harassment that occurred during the time plaintiff's claim was ripe. "***A statute of limitations does not operate to bar the introduction of evidence that predates the commencement of the limitations period but that is relevant to events during the period.***" *Id.* at 365.[30]

CitiGroup had an extensive and extremely close relationship with Enron. CitiGroup provided ***both*** commercial banking and investment banking services to Enron, helped structure and finance Enron's secretly controlled LJM2 partnership and its illicit transactions with SPEs that helped Enron create phony profits and hide debt, and also engaged in manipulative or deceptive contrivances to enable Enron to falsify its financial statements and misrepresent its financial condition by hiding over $2.4 billion in debt that should have been on Enron's balance sheet. At the same time, CitiGroup's ***securities analysts were issuing extremely positive – but false and misleading – reports on Enron, extolling Enron's business success, the strength of its financial condition and its***

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transactions not charged in the indictment but used to help support scheme allegations could be properly admitted. "The fact that a number of the overt acts performed in furtherance of the conspiracy were committed beyond the statute of limitations does not preclude the admission in evidence of such acts to show the nature of the scheme and [the commissioner's] intent where the later use of the mails occurred."). Although these cases relate to evidentiary issues, the same reasoning should apply in this case at the motion to dismiss stage. If evidence can be admissible at trial regarding defendants' earlier acts in furtherance of their scheme then so too should allegations regarding actions taken beyond the statute of limitations be considered at the pleading stage.

[30] In *Black Law Enforcement Officers Ass'n v. City of Akron*, 824 F.2d 475 (6th Cir. 1987), the Sixth Circuit found the lower court erred when it granted a motion by the city seeking to limit evidence presented in the case to events that occurred within the one year statute of limitations period. *Id.* at 479. "It is clear that the district court erred in using the statute of limitations to bar the admission of evidence. The function of the statute of limitations is to bar stale claims." *Id.* at 482-83. "'The statute of limitations is a defense ... not a rule of evidence. Therefore ... [it] has no bearing on the admissibility of evidence.'" *Id.* at 483. The Sixth Circuit found that plaintiffs were correct in offering evidence of events extending beyond the statute of limitations ***as admissible to show motive, intent or continuing scheme***. *Id.* (citing *United States v. Garvin*, 565 F.2d 519, 523 (8th Cir. 1977)).

prospects for strong earnings and revenue growth.[31] In return for CitiGroup's participation in the

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[31] As the CC explains, the banks named as defendants all evolved into their present form after the repeal of the Glass-Steagall Act in 99. That law prohibited banks from acting in such dual capacities, and was enacted to remedy abuses that occurred in the 20s when banks sold securities of, and made loans to, their corporate customers. With the repeal of Glass-Steagall, the banks sued here, including CitiGroup, quickly morphed back into financial services institutions offering commercial ***and*** investment banking services to corporate customers. The abuses of the 20s quickly returned as well. ¶¶643-644. According to *Business Week*:

> After the stock market crashed in 1929, Congress hauled in Wall Street bosses to explain how bankers helped companies inflate earnings for a decade through complex structures. Congress scrutinized bank practices for years, then passed the Glass-Steagall Act, splitting commercial banks from brokerages. That checked the Street's temptation to monkey with clients' finances while flogging their stock.
>
> Now Congress needs answers from Wall Street's chiefs again. Congress repealed Glass-Steagall in 1999, under pressure from bankers ***who swore they would manage such conflicts of interests. They would erect so-called Chinese Walls that forbade sharing information between those selling a company's stock and those arranging its financing***.
>
> ***But the Chinese walls are porous. Bankers ignore them when it's convenient: They take analysts on road shows of investment-banking clients – their way of making it clear they don't want downgrades of those companies***. The walls also provide cover for bankers, who let analysts push a client's stock even when they know the company is in trouble. That's why analysts recommended Enron to the end, though the bankers behind its complex financing knew it was on the skids.

Business Week, 3/25/02 (¶643).

According to the *Miami Herald* on 3/19/02 (¶644):

> ***Banks Tangled in Fall of Enron***
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> * * *
>
> They are the titans of Wall Street, possessing pedigrees that date to the founding of America and wealth greater than many nations.
>
> * * *
>
> Empowered by the massive deregulation of financial services they zealously sought, New York's investment banks created their masterpiece in Enron, providing every conceivable product and service.
>
> ***They lent it money, often without collateral. They sold its securities to an unsuspecting public. They wrote rosy, inaccurate analyst reports.***
>
> ***They were pivotal players in the mysterious offshore partnerships that ultimately brought Enron down.***
>
> Wearing so many hats was unthinkable a generation ago, when laws kept the

scheme, it received huge underwriting and consulting fees, interest payments, commitment fees and other payments from Enron and related entities. Also, CitiGroup or top executives of CitiGroup were permitted to personally and secretly invest $15 million in Enron's lucrative LJM2 partnership as a reward to them for orchestrating CitiGroup's participation in this fraud, while Enron secretly paid CitiGroup grossly excessive interest rates on billions of dollars of concealed/disguised loans. ¶¶674-675, 687.

CitiGroup engaged and participated in the fraudulent scheme and course of business in several ways. It participated in ***disclosed*** commercial loans and lending commitments of over $4 billion to Enron during the Class Period. CitiGroup also helped raise some $3.5 billion from the investing public for Enron via the sale of Enron and Enron-related securities during the Class Period, sales accomplished via false Registration Statements. CitiGroup also helped structure and finance certain of the partnerships Enron controlled and their illicit transactions with SPEs, knowing they were vehicles being utilized by Enron to falsify its reported financial results. CitiGroup also engaged in contrived and deceptive transactions with Enron to disguise billions of dollars in loans to Enron, thus helping Enron falsify its true financial condition, liquidity and creditworthiness. ¶675.

CitiGroup acted as an underwriter of billions of dollars of Enron securities, including (¶677):

DATE	SECURITY
11/93	8 million shares Enron capital 8% preferred shares at $25 per share, raising $200 million
7/94	3 million shares 9% Enron capital preferred shares at $25 per share, raising $75 million
1/95	$150 million 8-1/2% Enron notes
5/95	$150 million 7-1/8% Enron notes
12/95	$210 million Enron exchangeable notes

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banking, brokerage and insurance industries separate. Deregulation changed all that, particularly in 1999 when the Depression-era Glass-Stegall Act was repealed....

* * *

Enron was such a lucrative customer that virtually every Wall Street firm had a relationship with it.

11/96	8 million shares 8.3% Enron capital preferred shares at $25 per share, raising $200 million
1/97	6 million shares Enron Capital Trust II 8-1/8% Preferred Securities at $25 per share, raising $150 million
8/97	$150 million 6.5% Enron notes
11/97	$300 million 6.45% Enron notes
9/98	$250 million Enron floating-rate notes
2/99	27.6 million shares Enron common stock at $31.34 per share, raising $870 million
8/99	$222 million 7% Enron exchangeable notes
2/01	$1.9 billion Zero Coupon Convertible Senior Notes

CitiGroup was a also major commercial lender to Enron, acting as a lead bank on Enron's main credit facilities.[32] For instance:

DATE	TRANSACTION
8/98	$1 billion Enron credit facility to back up commercial paper
6/01	$600+ million loan for Dabhol power project
7/01	$582 million loan to Enron
8/01	$3 billion Enron credit facility to back up commercial paper
11/01	$1 billion secured loan to Enron

¶680. CitiGroup's commercial paper back-up credit facilities for Enron were ***extremely significant***. They enabled Enron to stay liquid by helping Enron maintain its access to the commercial paper

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[32] In analyzing potential borrowers on commercial loans or credit facilities, CitiGroup was required to perform extensive credit analysis of the borrower after obtaining detailed financial information from it. Included in this credit analysis is a detailed review of the borrower's actual and contingent liabilities, its liquidity position, any equity issuance obligations it may have which could adversely affect its shareholders' equity, any debt on which the borrower may be potentially liable, even if not on the borrower's books directly, the quality of the borrower's profits on earnings and the borrower's actual ***liquidity***, including sources of funding to support repayment of any loans. In addition, when CitiGroup made large loans to or committed itself to credit facilities for a corporation, it was required to closely monitor the company by frequently reviewing its financial condition and ongoing operations for any material changes and insist that top financial officers of the borrower keep it informed of the current status of the borrower's business and financial condition. As a result, CitiGroup obtained and retained extremely detailed information concerning the actual financial condition of Enron throughout the Class Period and was aware that the actual condition of Enron's business, its finances and its financial condition was far worse than was being publicly disclosed by Enron, or as described or disclosed in each of CitiGroup's analyst reports on Enron. ¶650.

market where it could borrow billions to finance day-to-day operations, while CitiGroup pocketed huge commitment fees on the back-up credit line. ¶19.

CitiGroup was willing to engage and participate in the fraudulent scheme and course of business because its participation created enormous profits for CitiGroup ***as long as the scheme continued*** – something that CitiGroup was in a unique position to cause. While CitiGroup was lending hundreds of millions of dollars to Enron, it was limiting its own risk in this regard, as it knew that so long as Enron maintained its investment grade credit rating and continued to report strong current period financial results and credibly forecast strong ongoing revenue and profit growth, ***Enron's access to the capital markets would continue to enable Enron to raise hundreds of millions, if not billions, of dollars of fresh capital from public investors which would be used to repay or reduce Enron's commercial paper debt and the loans from CitiGroup to Enron so that the scheme could continue***. ¶683.

In fact, the proceeds of Enron's securities offerings during the Class Period underwritten by CitiGroup or other banks were utilized to repay Enron's existing commercial paper and bank indebtedness, including indebtedness to CitiGroup. Thus, throughout the Class Period, CitiGroup was pocketing millions of dollars a year in interest payments, syndication fees and investment banking fees by participating in the Enron scheme to defraud and stood to ***continue*** to collect these huge amounts on an annual basis going forward so long as it helped perpetuate the Enron Ponzi scheme, ***while CitiGroup pocketed huge returns on its secret investment in LJM2 – returns created by the very fraudulent acts and contrived transactions between Enron and LJM2 entities which CitiGroup was financing – and which were hiding billions of Enron's debt and artificially inflating its profits by hundreds of millions of dollars***. ¶683.

In addition, CitiGroup also engaged and participated in the scheme to defraud by ***making false statements to the market regarding Enron***. First of all, the Registration Statements for Enron's 2/99 27.6 million share stock sale, Enron's 8/99 $222 million 7% Enron exchangeable note sale and the 10/00 New Power IPO where CitiGroup was one of the lead underwriters contained false and misleading statements – ***which are statements made by CitiGroup as an underwriter*** – including Enron's false interim and annual financial statements, and other false statements

concerning the structures, of and Enron's relationship to, SPEs and related parties, Enron's financial risk management statistics, as well as the condition of Enron's business operations and the value of its assets. ¶685. *See infra* at 95-96.

In addition, throughout the Class Period, CitiGroup ***issued*** 18 analysts' reports on Enron which contained false and misleading statements concerning Enron's business, finances and financial condition and prospects, including those dated 10/22/98, 1/27/99, 7/20/99, 8/20/99, 9/20/99, 10/20/99, 4/12/00, 7/19/00, 7/24/00, 9/21/00, 10/18/00, 3/12/01, 3/22/01, 5/18/01, 6/7/01, 7/13/01, 10/16/01 and 10/19/01. ¶¶123, 133, 163, 166, 169, 186, 227, 244, 249, 259, 267, 304, 308, 326, 327, 335, 370 and 375. ¶686. *See infra* at 74-94.

These were all statements by CitiGroup to the securities markets which helped artificially inflate the trading prices of Enron's publicly traded securities. ***Keeping Enron's stock price inflated was also important to CitiGroup as a major investor in and lender to LJM2, as it knew that if the stock price fell below various "trigger" prices, Enron would be required to issue millions of additional Enron shares, which would reduce Enron's shareholders' equity by hundreds of millions, if not billions, of dollars, endanger its investment grade credit rating, likely cut off its access to the capital markets, and thus endanger the ongoing scheme from which CitiGroup was profiting***. ¶686.

In addition to making its own false statements, CitiGroup participated in and furthered the fraudulent scheme by helping to finance or otherwise participate in illicit transactions with Enron which it knew would contribute materially to Enron's ability to continue to falsify its financial condition and thus continue the operation of the Enron Ponzi scheme. ¶684.

CitiGroup and Enron engaged in secret, fraudulent transactions utilizing an entity which CitiGroup controlled (Delta) located in the Cayman Islands. From late 99 through early 01, CitiGroup lent Enron $2.4 billion in a series of contrived transactions. These transactions were structured to appear as natural gas futures contracts, *i.e.*, commodity trades, between Enron and Delta. However, these transactions were manipulative or deceptive contrivances and devices to falsify Enron's financial condition – in reality, disguised loans from CitiGroup to Enron, that CitiGroup created to get cash to Enron to boost its apparent liquidity, allow it to inflate its revenues

and conceal billions of dollars of debt that should have been reported on Enron's balance sheet. ¶¶45, 684.

In a true swap, two parties trade the future returns on investments over a set period of time. One party pays a small amount to receive a fixed interest rate on a corporate bond in lieu of uncertain gains on the same corporation's stock. The counterparty accepts the payment and swaps the return on the bond for the return on the stock. Neither party actually needs to hold the underlying assets, as long as the payments are made. Typically, neither party in a true swap exchange receives all the agreed payments up front. In the Enron transactions, though, CitiGroup paid up front an estimate of the fair value of its portion of the swaps – hundreds of millions of dollars each time – payments made ***immediately. Enron was obliged to repay the cash over five years***. These Delta transactions, though technically derivatives trades known as prepaid swaps, perfectly replicated loans and were, in fact, manipulative or deceptive devices to disguise what were, in reality, loans. Enron's balance sheet misrepresented these transactions. Enron posted the loans as "assets from price risk management" and as "accounts receivable." The repayments that Enron owed the banks were listed as "liabilities from price risk management." ¶¶44-47, 684.

CitiGroup knew these transactions were devices and contrivances to deceive investors and that, given the true financial condition of Enron, there was a risk Enron would default and CitiGroup would suffer a loss. Therefore, CitiGroup took unusual steps to mitigate its credit exposure to Enron because of its knowledge that Enron's true financial condition was much more precarious than publicly disclosed and that Enron was falsifying its true financial condition and financial results. To try to insulate itself from the losses it faced due to Enron's true financial condition and fraudulent course of business, CitiGroup created securities that functioned like an insurance policy for its credit exposure to Enron. If Enron remained solvent and strong, buyers of the securities would receive a steady return, but if Enron was unable to pay its bank debt, CitiGroup would stop paying the return, keep the investors' principal and instead give them Enron's now worthless or impaired debt. The securities which covered CitiGroup's potential losses from Enron totaled $2.4 billion and were issued from 8/00 to 5/01. CitiGroup set up paper companies in the Channel Islands, the first in 8/00 and three more in 5/01, which offered five-year notes. The companies sold investors a type of credit

derivative called credit-linked notes. If the notes' five-year terms elapsed without incident, CitiGroup would return the investors' principal. But if Enron went bankrupt, CitiGroup would take possession of the highly rated securities and give the investors unsecured Enron debt instead. The notes worked like an insurance policy: CitiGroup paid a premium in the form of interest payments, and if Enron collapsed, the bank would receive significant compensation in the form of high-quality securities. ***This hedge was CitiGroup's largest against any company in its history. In fact, this hedge was the largest of its kind ever.*** ¶681.

These phony commodity transactions were frequently entered into ***just before quarter- or year-end so that they would enable Enron to keep debt off its balance sheet by disguising it as commodities trades, thus keeping Enron's reported or disclosed debt level down, helping to maintain its investment grade credit rating, and allowing the Enron Ponzi scheme to continue. The disguised commodity trades concealed the true extent of Enron's debt and provided this part of the scheme to Enron, creating a synergistic situation where Enron's interests were directly served by permitting it to hide approximately $2.4 billion in loans to it, while permitting CitiGroup to profit by charging excessive interest rates and fees for its role in putting together these phony transactions in the Cayman Islands***. Knowing that Enron's true financial condition was far more precarious than publicly known, thus increasing the chance of default and that it was engaging in a secret illegal contrivance, CitiGroup not only hedged its credit risk, it also forced Enron to pay grossly excessive rates for these disguised loans – 300 basis points – 3% over normal market rates on $2.4 billion in loans – a $70 million per year payoff to CitiGroup in return for its participation in these bogus and dangerous transactions. ¶¶44-47.

CitiGroup was also the lead underwriter in the New Power IPO which enabled Enron to improperly create and recognize a $370 million profit in the 4thQ 00. In 00, Enron owned millions of shares of New Power stock – then a private company – and controlled New Power. In late 00, Enron desperately needed to create profits to perpetuate the Ponzi scheme. If Enron could take New Power public and create a trading market in its stock, then Enron could recognize a profit on the gain in value on its shares by "hedging" that gain via yet another non-arm's-length transaction with an LJM2 SPE entity. Enron and CitiGroup did the huge New Power IPO – 27.6 million shares at $21

per share in 10/00. In a deal secretly structured before the IPO, Enron quickly moved to create a huge phony profit using LJM2 (which CitiGroup was funding and administering) via an SPE called Hawaii 125-0. Several other of Enron's banks (including CitiGroup) made a "loan" of $125 million to Hawaii 125-0, but received a secret "***total return swap***" guarantee that was to protect them against ***any loss*** from Enron. Enron transferred millions of its New Power warrants to Hawaii 125-0 to "secure" the banks' loan and thus created a huge $370 million "profit" on the purported gain on the New Power warrants made possible by the New Power IPO. Hawaii 125-0 supposedly "hedged" the warrants with another entity created and controlled by Enron called "Porcupine." To supposedly capitalize Porcupine, LJM2 put $30 million into Porcupine to facilitate the so-called hedge of the New Power warrants, but, ***one week later***, Porcupine paid the $30 million back to LJM2 plus a $9.5 million profit – leaving Porcupine with no assets. During 01, New Power stock fell sharply, converting Enron's huge gain on its New Power equity holdings into a huge loss (about $250 million), which Enron concealed. ¶¶42, 679.

A primary vehicle utilized to falsify Enron's reported financial condition and results during the Class Period was LJM2, which was secretly controlled by Enron and was used to help create and finance numerous SPEs (including the infamous Raptors) with which Enron engaged in contrived transactions to artificially inflate Enron's profits while concealing billions of dollars in debt that should have been on Enron's balance sheet.

It was indispensable that LJM2 be funded before year-end 99 because of the need to fund new SPEs to deal with Enron to create huge 4thQ 99 profits for Enron so it could meet its forecasted 99 earnings and move hundreds of millions of dollars of debt off Enron's balance sheet. CitiGroup knew, because LJM2 was going to be principally utilized to engage in transactions with Enron where Enron insiders (Fastow, Kopper and Glisan) would be on both sides of the transactions, that the LJM2 partnership would be extremely lucrative – virtually guaranteed to provide huge returns to LJM2's investors. ¶¶24-27, 646. However, there was tremendous time pressure and Merrill Lynch could not raise the money from outside investors in LJM2 in time to fund LJM2 by year-end 99 with sufficient capital to enable it to do the desperately needed transactions with Enron. So, in an extraordinary step, certain of Enron's banks and bankers, including CitiGroup, knowing that LJM2

was going to be an extraordinarily lucrative investment, put up $1,500,000 early – many times more than their allocated shares – on or about 12/22/99 – which, when combined with early funds put up by certain other banks that were in on the scheme, provided monies needed to pre-fund LJM2.[33] This early funding on 12/22/99 provided funding to enable Enron to engage in the Whitewing, CLO, Nowa Sarzyna Power Plant, MEGS natural gas and Yosemite certificates deals between 12/22-29/99. These were SPE deals funded by LJM2 – transactions that generated millions in phony profits for Enron, just before year-end 99, and moved hundreds of millions of dollars of debt off Enron's balance sheet. These deals, which were nothing more than contrivances to deceive, were then "undone" in the 1stQ 00 with huge returns to LJM2's investors – CitiGroup and other banks. ¶¶24-28, 466-475, 646-647.

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[33] After LJM2 was fully funded in early 00 as other investors' money flowed into LJM2, the banks' "over-funding" in 12/99 was adjusted for in the subsequent capital contributions to LJM2. The reason the banks put up virtually all the money to fund LJM2 in 12/99 was that they knew Enron doing the 99 year-end deals with the LJM2 SPEs was indispensable to avoiding Enron reporting 4thQ 99 and year-end 99 results below expectation – which would have caused its stock to plunge and impaired the continued viability of the Enron Ponzi scheme from which they were all benefitting. ¶647. This is shown below:

LJM2 PARTNERSHIP FUNDING

Partnership Investor	Bank	Total LJM-2 Funding Commitment	% of Fund	Pre-Funding 12/22/99	2d/3d Close Draw	4th Close Draw	Net Investment @ 6/30/00
Chemical Investments, Inc , J P. Morgan Partnership Investments Corp ; Sixty Wall Street Fund, LP	JP Morgan	$ 25,000,000	6 3928%	3,750,000	$ (1,688,475)	$ (894,485)	$ 1,167,040
CIBC Capital Corporation	CIBC	$ 15,000,000	3 83568%	2,250,000	$ (1,013,085)	$ (536,679)	$ 700,236
Citicorp, Travelers, Primerica	CitiGroup	$ 15,000,000	3 83568%	1,500,000	$ (675,390)	$ (106,470)	$ 718,140
BT Investment Partnership, Inc.	Deutsche Bank	$ 10,000,000	2 55712%	1,500,000	$ (675,390)	$ (357,786)	$ 466,824
DLJ Fund Investment Partners III, L P	CS First Boston	$ 5,000,000	1 27856%	750,000	$ (337,695)	$ (178,893)	$ 233,412
LBJ Group Inc	Lehman	$ 10,000,000	2.55712%	1,500,000	$ (675,390)	$ (357,786)	$ 466,824
MLJDX Positions, Inc , Louis Chiovacci, ML/LJM2 Co-Investment, LP	Merrill Lynch	$ 22,645,000	5 79059%	750,000	$ (337,695)	$ 707,820	$ 1,120,125
Papyrus I Funding Trust	Bank America	$ 45,000,000	11 50703%			$ 2,261,844	$ 2,261,844

To the extent that Enron's banks – including CitiGroup – were permitted to invest in LJM2, ***this was a reward to them for their ongoing participation in the scheme.*** ¶¶25, 646. ***In this regard, as a reward for its participation, CitiGroup was permitted to ultimately invest $15 million in LJM2 which facilitated the financing of that critical vehicle.*** Also, CitiGroup ***acted as the administrator of the LJM2 partnership's affairs*** and thus ***was aware of all of its deals with the SPEs to boost Enron's reported results, as well as how it was self-dealing with Enron's assets and providing huge returns to these LJM2 investors like itself.*** ¶27. According to *The New York Times*:

> ***Enron Ex-Chief Said to Voice Suspicion of Fraud***
>
> Jeffrey K. Skilling, the former chief executive of Enron, has told investigators that the top flight financial returns that investors made from a partnership that did business with the company ***could have been achieved only if the corporation was defrauded, according to documents and people involved in the case***.... He indicated to the S.E.C. ... that such returns – which were as high as 2,500 percent in one transaction – ***could not have been achieved through arm's-length transactions*** .... Mr. Skilling was said to have grown agitated as he described his opinion of the information.... Mr. Skilling made his statements to investigators after reviewing LJM2 records.... [LJM2] investors were told that the partnership had generated rates of return on its investments in the Raptor ranging from just more than 150 percent to 2,500 percent.

Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicions of Fraud," *New York Times*, 4/24/02.

During 00-01, the LJM2 partnership, with ongoing funding from CitiGroup, was able to form and finance numerous SPEs – ***including the Raptors*** – with which Enron engaged in transactions to inflate its reported profits, while moving billions in debt off Enron's balance sheet. ¶647. Not only did these favored investors in LJM2 like CitiGroup get a promise of superior returns after LJM2 was formed – they actually ***witnessed*** and ***benefitted from*** a series of extraordinary payouts from the Raptor SPEs which LJM2 controlled over the next two years – securing hundreds of millions of dollars in distributions from the Raptors to LJM2 and ***then to themselves*** – cash generated by the illicit and contrived transactions Enron was engaging in with the Raptors to falsify its financial results. Thus, the banks and bankers who were partners in LJM2 like CitiGroup ***were not only***

knowing participants in the Enron scheme to defraud, they were direct economic beneficiaries of it – the looting of Enron. ¶649.[34]

After LJM2 was formed and CitiGroup had secretly helped to pre-fund LJM2 in 12/99 and secretly been permitted to invest in LJM2 (ultimately to the tune of over $15 million), to help fund numerous non-arm's-length fraudulent transactions to artificially boost Enron's reported profits and hide billions of dollars of its debt, and after CitiGroup was engaging in the contrived Delta transactions to conceal billions of dollars in loans to Enron, CitiGroup continued to issue very positive analyst reports on Enron. These reports contained "boilerplate" disclosures like:

> We may from time to time have long or short positions in any buy and sell securities referred to herein. The firm may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in this report.

These boilerplate disclosures continued the same as they were before 12/99 – i.e., they did not change in any substantive way after CitiGroup pre-funded LJM2 in 12/99 and secretly became an investor in LJM2 or administered its affairs or engaged in the multi-billion dollar Delta transactions with Enron to generate bogus profits for Enron while hiding billions of dollars of its debt. The failure to disclose the LJM2 investments of CitiGroup, CitiGroup's large loans to LJM2 or the multi-billion dollar Delta transactions with Enron made CitiGroup's "boilerplate" disclosure false and misleading and concealed from the market the very significant and serious conflict of interests which Enron and CitiGroup knew would have cast serious doubts on the objectivity and honesty of CitiGroup's analyst reports on Enron and disclosed that CitiGroup had compromising ties to and serious conflicts of interest regarding Enron. ¶29.

IV. CITIGROUP CAN BE LIABLE UNDER 1934 ACT §10(b) AND RULE 10b-5 (i) FOR MAKING FALSE STATEMENTS, OR (ii) FOR PARTICIPATING IN A FRAUDULENT SCHEME OR COURSE OF BUSINESS THAT OPERATED AS A FRAUD OR DECEIT ON PURCHASERS OF ENRON'S SECURITIES, OR (iii) FOR EMPLOYING ACTS OR MANIPULATIVE DEVICES TO DECEIVE

Plaintiffs here have also pleaded and are pursuing theories of recovery against CitiGroup that are well-grounded in the express language of the 1934 Act. Section 10(b) of the 1934 Act states:

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[34] ***These payments from LJM2 were on top of the huge advisory fees***, underwriter fees, interest and loan commitment fees CitiGroup was already getting from Enron. ¶649.

Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly ...

* * *

(b) [t]o use or employ, in connection with the purchase or sale of any security ... ***any manipulative or deceptive device or contrivance*** in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[35]

15 U.S.C. §78j(b).

Rule 10b-5 promulgated by the SEC flows directly from the language of §10(b) itself and provides:

§240.10b-5 Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. §240.10b-5.

Not only does Rule 10b-5 forbid the making of "any untrue statement of a material fact," it also provides for scheme liability. Scheme liability is authorized by the text of §10(b). According to the Supreme Court, §10(b)'s prohibition of "any ***manipulative or deceptive device or contrivance***" necessarily encompasses any "***scheme to defraud.***" In *Ernst & Ernst*, the Court referred to the dictionary definitions of §10(b)'s words, to find that a "device" is "'[t]hat which is devised, or formed by design; a contrivance; an invention; project; ***scheme; often, a scheme to deceive***; a stratagem; an artifice.'" 425 U.S. at 199 n.20 (quoting *Webster's International Dictionary* (2d ed. 1934)). The

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[35] Note that §10(b) itself does not expressly prohibit untrue statements of material facts or material omissions. This prohibition, like the prohibition against fraudulent schemes and fraudulent courses of business, is expressed in Rule 10b-5.

Court found that a "contrivance" means "'***a scheme, plan, or artifice.***'" *Id.* (quoting *Webster's International Dictionary*); *see also Aaron*, 446 U.S. at 696 n.13. Clearly, "scheme" is encompassed in the broad language of §10(b).

Thus, Rule 10b-5 – adopted by the SEC to implement §10(b) – makes it unlawful for any person "***directly or indirectly***" to employ "***any*** device, ***scheme***, or artifice ***to defraud***," "***to make any untrue statement[s]***," or to "***engage in any act, practice, or course of business which operates ... as a fraud or deceit upon any person***." 17 C.F.R. §240.10b-5. *See also U.S. Quest*, 228 F.3d at 407.

Prior to the Supreme Court's endorsement of the presumption of reliance based on the fraud-on-the-market theory for both misrepresentations and omissions in *Basic*, 485 U.S. 224, the Fifth Circuit had held that the theory applied ***only*** to omission cases and not misrepresentation cases. Thus, in some instances, securities plaintiffs sought recovery under subsection (a) and (c) of Rule 10b-5 alleging ***fraudulent scheme and course of business liability***. The Fifth Circuit expressly recognized the validity of these theories of recovery.

For instance, in *Finkel*, 817 F.2d 356, plaintiff sued under §10(b) and Rule 10b-5, claiming that the stock of Docutel was inflated due to false financial reports. According to plaintiff, Olivetti (which owned 46% of Docutel and controlled it) forced Docutel to buy Olivetti's excess inventories at inflated prices so Olivetti could hide losses it was suffering. Docutel concealed this financial manipulation for some time but, when its auditors discovered the financial manipulation and forced a large inventory writedown, huge losses were disclosed and Docutel stock fell. The district court dismissed the complaint against Olivetti and Docutel because plaintiff failed to allege reliance on any of the false statements in Docutel's SEC filings, etc. that were alleged in the Complaint.

> But the fact that the complaint lists a number of documents filed with the SEC does not limit plaintiff's claim to subsection (2) only. For, as in *Shores*, plaintiff's lack of reliance on these documents does not resolve the claims made under 10b-5(1) and (3). ***We find that plaintiff's complaint properly alleges a scheme to defraud or course of business operating as a fraud for purposes of the first and third subsections; plaintiff's complaint, taken as a whole, alleges that Olivetti forced Docutel to take its worthless inventories, that this scheme or course of business was not disclosed, and that the effect was to defraud certain purchasers of Docutel.***

* * *

> The most significant event which allegedly led to the loss by plaintiff is the claim that Olivetti forced Docutel to take worthless inventories without disclosing that fact in the marketplace; ***if proved, that conduct could equate with a scheme to defraud or course of business operating as a fraud in violation of 10b-5(1) and (3)***. Thus, we conclude that the district court erred in its dismissal of the complaint as to plaintiff's claims under 10b-5(1) and (3).

Id. at 363-64; *accord Heller v. Am. Indus. Props. Reit*, No. SA-97-CA-1315-EP, 1998 U.S. Dist. LEXIS 23286, at *14 (W.D. Tex. Sept. 28, 1998) ("The first and third subsections, on the other hand, ***create a duty not to engage in a fraudulent scheme or course of conduct*** ....").

Thus, the Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading Offering Circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that Offering Circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme***." *Shores*, 647 F.2d at 468.

The fraudulent scheme and course of business involving Enron ***was worldwide in scope, years in duration and unprecedented in scale*** and required the skills and active participation of lawyers, bankers and accountants to help design, implement, conceal and falsely account for the deceptive acts and devices, manipulative or deceptive contrivances and artifices they and Enron were using to falsify Enron's reported profits and financial condition and to continue its fraudulent course of business.

The notion that *Central Bank*, 511 U.S. 164, issued a broad edict that lawyers, bankers and accountants are immune from liability for their participation in complex securities frauds is nonsense. *Central Bank* expressly recognized: "The absence of §10(b) aiding and abetting liability ***does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer ... or bank who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser ... relies may be liable as a primary violator under 10b-5.... In any complex securities fraud, moreover, there are likely to be multiple violators***." *Id.* at 191. A scheme to defraud often will involve a variety of actors, and investors are entitled to allege "***that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or***

deceptive act in furtherance of the scheme." *Cooper*, 137 F.3d at 624; *accord SEC v. First Jersey Sec. Litig.*, 101 F.3d 1450, 1471 (2d Cir. 1996); *In re Health Mgmt. Inc. Sec. Litig.*, 970 F. Supp. 192, 209 (E.D.N.Y. 1997); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 969-70 (C.D. Cal. 1994).

In *Central Bank*, 511 U.S. 164, a public building authority issued bonds to finance public improvements. Central Bank served as indenture trustee. The bonds were secured by liens covering property. The bond covenants required that the liened land be worth at least 160% of the principal amount of the bonds. Central Bank got a letter expressing fear that property values were declining and that perhaps the 160% value test was no longer met. The bank did nothing. Soon afterwards, the public building authority defaulted on the bonds. The bonds were not publicly traded. Central Bank, which had no commercial lending relationship with the municipal entity involved, and which was not an investment bank, issued no analysts' reports about the issuer of the municipal bonds and thus, made no statement and took no affirmative act that could have affected the trading price of the municipal bonds in issue. Clearly, this is a significantly different fact pattern from Enron.

The *Central Bank* majority noted that their reasoning was "confirmed" by the fact that if they accepted the plaintiffs' aiding and abetting argument it would impose §10(b) liability when "at least one element critical for recovery" was absent, *i.e.*, reliance. *Id.* at 180 (citing *Basic,* 485 U.S. at 243 (the Supreme Court's "***fraud-on-the-market***" decision) for the proposition that a plaintiff must show reliance to recover under Rule 10b-5). "Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements ***or actions***." *Id.* The Court found that allowing plaintiffs to "circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery as mandated by our earlier cases." *Id.* However, in this case, the alleged scheme and fraudulent course of business ***inflated*** the prices of Enron's ***publicly traded*** securities. ¶¶74, 418-424, 674-692. Thus, the reliance element is not "***absent***" and the Court's prior decision in *Basic* is not circumvented – ***it is satisfied***.

Central Bank thus denied recovery to victims of an alleged securities fraud who pleaded only one theory of recovery against the defendant bank – secondary liability dubbed "aiding and abetting." 511 U.S. at 191. However, the words aiding and abetting do not appear in §10(b) or Rule 10b-5.

The Court said "***the text of the 1934 Act does not itself reach those who aid and abet a §10(b) violation ... that conclusion resolves the case.***" *Id.* at 177. The *Central Bank* plaintiffs did not, as the plaintiffs do here, plead or pursue recovery under the theory that the bank defendant made false and misleading statements in Registration Statements or other documents issued to the public, *e.g.*, analysts' reports ***or*** employed acts and manipulative or deceptive devices or engaged in a fraudulent scheme or course of business that operated as a fraud or deceit on purchasers of the securities in issue. In the words of the Court, the plaintiffs "concede that Central Bank did not commit a manipulative or deceptive ***act*** within the meaning of §10(b)." *Id.* at 191. Thus, because the *Central Bank* plaintiffs pursued a theory of recovery which found ***no support in the text of either the statute or the rule, they lost.***

Central Bank cannot mean that a defendant cannot be liable under §10(b) unless it made misleading statements because the Court rejected that argument in *O'Hagan*, 521 U.S. 642. The Eighth Circuit had held that, under *Central Bank*, "§10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely." *Id.* at 664. The Court reversed, holding that §10(b) does not require a defendant to speak. *Id.* Because §10(b) prohibits "'any manipulative or deceptive device or contrivance'" in contravention of SEC rules, this reaches "any deceptive device," whether or not the defendant spoke. *Id.* at 653. *Superintendent of Ins.*, 404 U.S. 6, is consistent with *O'Hagan*. In *Superintendent of Ins.*, a ***unanimous*** Court upheld a §10(b)/Rule10b-5 complaint involving a "fraudulent scheme" involving the sale of securities where ***no*** false statement was alleged because:

> ***There certainly was an "act" or "practice" within the meaning of Rule 10b-5 n.5 which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds.***

Id. at 9 (footnote omitted). This Court has stated, citing *O'Hagan*, that:

> ***A defendant need not have made a false or misleading statement to be liable.***

Landry's, slip op. at 9 n.12; *Waste Mgmt.*, slip op. at 75; *BMC Software*, 183 F. Supp. 2d at 869. ***Here, of course, CitiGroup made false statements in Registration Statements and analysts' reports.***

That this reading of §10(b)/Rule 10b-5 is clearly correct is shown by a new ***unanimous*** Supreme Court decision – *Zandford*, 2002 U.S. LEXIS 4023. In *Zandford*, the Court repeatedly cited with approval its seminal "***fraudulent scheme***" case *Superintendent of Ins.*, and reversed dismissal of a §10(b)/Rule 10b-5 complaint making the following key points:

- "***The scope of Rule 10b-5 is coextensive with the coverage of §10(b)*** ...." *Id.* at *7 n.1.
- "***[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security" to violate §10(b)***. *Id.* at *13.[36]
- Allegations that defendant "'***engaged in a fraudulent scheme***'" or "'***course of business that operated as a fraud or deceit***'" stated a §10(b) claim. *Id.* at *13, *14-*17.

Central Bank clearly – ***but merely*** – stands for the proposition that no aiding and abetting liability exists under the 1934 Act because neither §10(b) nor Rule 10b-5 contain "aiding and abetting" language. The decision in *Central Bank* is ***quite narrow***. By contrast, the language of §10(b) and Rule 10b-5 is ***very broad***. Also, the purposes of §10(b) and Rule 10b-5 are remedial, intended to provide access to federal court to persons victimized in securities transactions:

> [T]he 1934 Act and its companion legislative enactments [including the 1933 Act] embrace a "fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry ...." Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes."

Affiliated Ute Citizens, 406 U.S. at 151 (footnote omitted). As noted by the Fifth Circuit:

> [T]he Court has concluded that the Exchange Act and the Securities Act should be construed broadly to effectuate the statutory policy affording extensive protection to the investing public. *See Tcherepnin*, 389 U.S. at 336, 88 S. Ct. at 553. *See also* S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933) (indicating legislative intent of the Securities Act to protect the public from the sale of fraudulent ***and speculative schemes***).

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[36] To the extent *Ziemba*, 256 F.3d at 1205, seems to require a statement be made about a company which is "publicly attributable to the defendant at the time the plaintiff's investment decision was made," it is inconsistent with *Zandford*.

Meason, 652 F.2d at 549. "The federal securities statutes are remedial legislation and must be construed broadly, not technically and restrictively. " *Paul F. Newton & Co.*, 630 F.2d at 1118.[37]

CitiGroup's claims that *Central Bank* eliminated fraudulent scheme or course of business liability is flawed. Notwithstanding *Central Bank*, primary liability may be based on participation in a scheme to defraud or a course of business that operated as a fraud or deceit on securities purchasers pursuant to subsections (a) or (c) of Rule 10b-5. Fraudulent scheme or course of business liability is viable because:

- It is encompassed by the ***express language*** of the statute, which prohibits the "direct or indirect" "use or employment" of "any manipulative or deceptive device or contrivance";
- It is encompassed by the ***express language*** of Rule 10b-5;
- It comports with the ***broad antifraud purposes*** of the statute;
- It has ***long been upheld*** by the courts; and
- It imposes liability based on a ***primary*** violation of the federal securities laws committed directly by the defendant that goes beyond merely assisting another in committing a violation.

In Central Bank, the plaintiffs did not allege primary liability against the bank, did not allege a scheme to defraud, did not allege a fraudulent practice or course of business and did not invoke subsections (a) or (c) of Rule 10b-5.[38] The plaintiffs alleged only that the bank was

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[37] The broad purposes of §10(b)'s prohibition of securities fraud and the Supreme Court's longstanding recognition of such broad purposes also support conspiracy and scheme liability. *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977) ("No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices."); *Affiliated Ute Citizens*, 406 U.S. at 152-53 (Proscriptions of §10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose ... to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.'") (footnote omitted) (quoting *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 186 (1963)); *Capital Gains Research*, 375 U.S. at 186 (§10(b) should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes"); *Superintendent of Ins.*, 404 U.S. at 11 n.7 ("'[We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that §10 (b) and Rule 10b-5 prohibit ***all*** fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'") (emphasis in original) (quoting *A. T. Brod & Co.*, 375 F.2d at 397).

[38] The *Central Bank* decision did not distinguish among the different subsections of Rule 10b-5.

"'***secondarily*** liable under § 10(b) for its conduct in ***aiding and abetting the fraud***.'" *Central Bank*, 511 U.S. at 168. The Court, therefore, did not address other liability theories. Yet CitiGroup offers up numerous rationales as to why *Central Bank* eliminated Rule 10b-5(a) and (c) liability. They are:

1. ***The "Textualist" Rationale***. The Court took a strict textualist approach in concluding that there is no private aiding and abetting liability under §10(b). Just as the statute does not explicitly mention "aiding and abetting," it also does not mention "scheme," "act," "practice," or "course of business."

2 ***The "Manipulation and Misrepresentation Is It" Rationale***. The Court stated that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," *Central Bank*, 511 U.S. at 177, which must be interpreted to mean that liability can only be premised upon conduct falling within subsection (b) of Rule 10b-5.

3. ***The "No More Secondary Liability" Rationale***. The Court's opinion holds that only primary violators may be held liable. Because scheme liability is a secondary liability theory similar to aiding and abetting, it is precluded.

None of these rationales for precluding fraudulent scheme and/or course of business liability is supportable because scheme and course of business liability is a ***textually-based, primary liability theory*** and there is no hard and fast rule that a defendant must make a false statement to face §10(b) liability – while in this case CitiGroup did, in fact, allegedly make several false and misleading statements.

None of the rationales as to how *Central Bank* eliminated Rule 10b-5(a) and (c) liability hold water.

- **The Flaws of the "Textualist" Rationale**

A major flaw of the textualist rationale is that scheme liability is ***firmly based*** on the language of both the statute and the rule. The statute itself contains only the general "***manipulative or deceptive device[s] or contrivance[s]***" language, leaving it to the SEC to more specifically proscribe fraudulent conduct. The SEC's rule-making authority would be superfluous if the rules it adopted had to use precisely the same words as in the statute. To be sure, "the private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of §10(b)," *Central*

Bank, 511 U.S. at 173, and "'the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit.'" *Id.* at 174 (quoting *Chiarella v. United States*, 445 U.S. 222, 234 (1980)). But it is patently reasonable for the SEC to have determined that the "employment" of a "scheme to defraud" and the "engagement" in a fraudulent "act, practice, or course of business" constitute the "use or employ[ment]" of a "manipulative or deceptive device or contrivance."[39]

In *Ernst & Ernst*, the Court implicitly found that a "scheme to defraud" falls within the meaning of the "manipulative or deceptive device or contrivance" language of §10(b). 425 U.S. at 199 n.20. The Court relied in part on the 1934 dictionary definitions of "device" and "contrivance." *See id.*; *see also Aaron*, 446 U.S. at 696 n.13 (relying on same definitions to find scienter requirement under §17(a)(1) of 1933 Act). Both of those definitions included a "scheme." *See Ernst & Ernst*, 425 U.S. at 199 n.20.[40]

The Court itself showed that *Central Bank* should not be interpreted as ushering in a new era of strict textualist construction of the federal securities laws. In upholding the misappropriation theory of insider trading in *O'Hagan*, 521 U.S. 642, the Court upheld a non-textual form of securities fraud and, in doing so, again exposed the long familiar broad expressions of the remedial purposes of the statute.[41]

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[39] No subsection of Rule 10b-5 has ever been successfully challenged in any court as being outside the scope of §10(b) in the 60-year existence of the Rule.

[40] The statutory prohibition against "directly or indirectly" violating §10(b) must cover a scheme to commit manipulative or deceptive acts. It is unlikely that Congress would have prohibited the direct commitment of a fraudulent act and yet approved the commission of the same fraudulent act through joint activity – *i.e.*, a scheme. The "directly or indirectly" language in §10(b) was not enough for the Supreme Court to save aiding and abetting liability in *Central Bank*. But that was because aiding and abetting liability covered a broader range of conduct than the direct commission of a manipulative or deceptive act. Scheme conduct, however, involves joint action to commit a manipulative or deceptive act that should itself be considered, directly or indirectly, a manipulative or deceptive act by each of the schemers.

[41] The Court also noted that the misappropriation theory is designed to protect the integrity of the securities markets against abuses and that the 1934 Act was enacted in part to insure the maintenance of fair and honest markets and thereby promote investor confidence. *O'Hagan*, 521 U.S. at 652, 657-59. For example, the Court stated that "[t]he theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence." *Id.* at 658. The Court detailed how investors would be hesitant to invest in an unfair market. *See id.*

- **The Flaws of the "Manipulation and Misrepresentation Is It" Rationale**

The Court in *Central Bank* said that §10(b) "prohibits only the making of a material misstatement (or omission) ***or the commission of a manipulative act.***" 511 U.S. at 177. It also indicated §10(b) liability existed where there was reliance on a defendant's "statements or actions." *Id.* at 180; *see also id.* at 191 ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming ***all*** of the requirements for primary liability under Rule 10b-5 are met.") (emphasis in original).

There is absolutely nothing in the language of the statute, the legislative history, or the Rule that warrants restricting liability solely to misrepresentations or omissions or certain technical forms of manipulation. The express language of §10(b) clearly allows for liability by a person who does not actually make a statement or omit to say something he is under a duty to disclose. The statutory language "directly or indirectly ... [t]o employ" in §10(b) is much broader than simply "directly to make." Similarly, the statutory language "any manipulative or deceptive device or contrivance" is much broader than simply "a misrepresentation or omission." Therefore, if the starting point in interpreting a statute is the language itself, *see Central Bank*, 511 U.S. at 173, there is no reason why liability under §10(b) must be limited to directly making misstatements or omissions or manipulating securities prices through certain specific technical or mechanical means.[42]

In addition, the SEC, in adopting subsections (a) and (c) of Rule 10b-5, implicitly recognized this. ***Unless this Court would strike down a rule that has been upheld for 60 years, the language "employ any device, scheme, or artifice to defraud" and "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit" in subsections (a) and (c) of Rule 10b-5 is much broader than simply "make a misrepresentation or omission."***[43]

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[42] As the Supreme Court has stated, "***[n]o doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices.***" *Santa Fe*, 430 U.S. at 477.

[43] Even from a common sense standpoint, schemes, acts, practices and courses of conduct can readily be manipulative or deceptive, irrespective of any statements or omissions.

If the Court in *Central Bank* meant to strike down subsections (a) and (c) of Rule 10b-5, the Court certainly would have explicitly said so. To the contrary, the courts have long recognized that the scope of liability under subsections (a) and (c) of Rule 10b-5 is broader than that under subsection (b), and that those who engage in a fraudulent scheme may be liable in the absence of misrepresentations or omissions. *See, e.g., Affiliated Ute Citizens*, 406 U.S. at 152-53 (subsections (a) and (c) are broader than subsection (b) of Rule 10b-5); *First Jersey*, 101 F.3d at 1471-72; *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1312 (9th Cir. 1982); *Shores*, 647 F.2d at 468 (*en banc*); *Competitive Assocs.*, 516 F.2d at 814-15 ("Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. ***Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted be the securities laws.***"); *Blackie v. Barrack*, 524 F.2d 891, 903 n.19 (9th Cir. 1975) ("Rule 10b-5 liability is not restricted solely to isolated misrepresentations or omissions; ***it may also be predicated on a 'practice, or course of business which operates ... as a fraud*** ...."'); *Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971) ("Rule 10b-5 is a remedial measure of far greater breadth than merely prohibiting misrepresentations and nondisclosures concerning stock prices. No attempt is made in 10b-5 to specify what forms of deception are prohibited; rather, ***all fraudulent schemes in connection with the purchase and sale of securities are prohibited.***") (emphasis added and in original).

- **The Flaws of the "No More Secondary Liability" Rationale**

The principal flaws of this rationale are that *Central Bank* did not strike down every form of "secondary" liability and that, in any event, violations through fraudulent schemes, acts, practices, or courses of business constitute primary violations of §10(b). In *Central Bank*, the Court did not make fine distinctions between conduct that constitutes a "primary" as opposed to that which constitutes a "secondary" violation of the statute. Nor did it hold that only "primary" violations are cognizable. It held that aiding and abetting could not constitute a violation because, as interpreted by the courts, aiders and abettors did not commit violations ***but only assisted them***, and the statute holds liable only those who commit violations.

Fraudulent acts, practices and scheme liability and course of business are ***primary*** liability theories in the sense that the defendant is directly liable for committing a violation of the statute. ***The fraudulent scheme, act, practice or course of business is a direct violation of §10(b) and Rule 10b-5.*** With respect to fraudulent acts, practices and a participation in the scheme to defraud or fraudulent course of business is itself the manipulative or deceptive act, even without the making of misrepresentations or omission. There is nothing derivative, vicarious or secondary about it. ***And CitiGroup here allegedly made false and misleading statements as well.***

All three subsections of Rule 10b-5 proscribe conduct for which a defendant may be ***primarily*** liable. Therefore, liability for a scheme to defraud or fraudulent act, practice or course of business does not run afoul of *Central Bank*'s elimination of aiding and abetting liability. Cases both before and after *Central Bank* have recognized that scheme liability is a form of primary liability. *Hill v. Hanover Energy, Inc.*, No. 91-1964 (JHG), 1991 U.S. Dist. LEXIS 18566 (D.D.C. Dec. 16, 1991), is an example of such a pre-*Central Bank* case. In *Hill*, the defendant argued that the §10(b) claim should be dismissed for failure of the plaintiff to allege any misrepresentations or omissions of material facts. *Id.* at *10-*11. The court rejected that argument, specifically finding that *Santa Fe* does not restrict §10(b) liability to misrepresentations or omissions. *See id.* at *11-*12. Rather, the court found that the alleged conduct of the defendant Hanover Energy, which included fraudulently inducing the plaintiff to give up his rights to acquire certain stock and to post a letter of credit, could fairly be viewed as manipulative or deceptive within the meaning of §10(b) and an unlawful scheme to defraud within the meaning of subsection (a) or (c) of Rule 10b-5. *See id.*[44]

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[44] District court decisions after *Central Bank* have continued to recognize scheme liability as a form of primary liability. For example, in *BMC Software*, 183 F. Supp. 2d at 885-86, this Court seemed to recognize scheme liability, although it found that the plaintiffs had failed to satisfy the pleading requirements. In *BMC Software*, when discussing the pleading requirements in securities fraud cases and what must be pled to support scheme allegations, this Court stated:

> As its first ground for dismissal, Defendants emphasize that the amended complaint fails to allege with any particularity that nine of the eleven individual Defendants made any representations or participated in any way in the alleged scheme to defraud.... ***Plaintiffs must allege what actions each Defendant took in furtherance of the alleged scheme and specifically pled what he learned, when he learned it, and how Plaintiffs know what he learned.***
>
> * * *

A scheme is "'[a] plan or program of something to be done.'"[45] A "scheme to defraud" encompasses any "plan designed or concocted for perpetrating a fraud." *Ballentine's Law Dictionary* 1142 (3d ed. 1969) ("scheme to defraud"). It has long included any scheme to defraud investors by

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> "***Primary liability may be imposed 'not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.***'"

Id. at 885-86, 904-05.

District court decisions before *Central Bank* also recognized scheme liability. In *ZZZZ Best*, the district court directly addressed Ernst & Young's liability under subsections (a) and (c) of Rule 10b-5, explicitly recognizing that liability under §10(b) and Rule 10b-5 is not restricted to material misstatements and omissions. 864 F. Supp. at 971-72 ("It appears that the scope of deceptive devices or schemes prohibited by subsections (a) and (c) [of Rule 10b-5] is quite extensive."). The plaintiffs alleged that Ernst & Young, hired to review the company's financial statements, was primarily liable because it participated in the creation of publicly released statements, issued a review report, and failed to disclose additional material facts related to the review report. Ernst & Young moved for dismissal on the grounds that it was really being charged with aiding and abetting liability precluded by *Central Bank*. The court denied the motion, concluding that the facts taken as a whole as to Ernst & Young's participation and knowledge could render it liable under a scheme to defraud. *Id.* at 969-72.

In *Adam*, the plaintiffs alleged that Deloitte & Touche was primarily liable under §10(b) for misrepresentations and "participation in a scheme to defraud" through its involvement with the issuer's press releases and financial statements. 884 F. Supp. at 1401. The plaintiffs also alleged that Deloitte knew of the inadequate controls and deviated from conducting its audits in accordance with generally accepted auditing standards. *Id.* at 1399. The court denied the accounting firm's motion to dismiss because it found that its participation in the preparation of the issuer's statements was part of a scheme to defraud, making the firm primarily liable under Rule 10b-5. *Id.* at 1399-1401. In so holding, the court recognized that Rule 10b-5(b) "essentially outlaws the making of a material misrepresentation or omission," but that subsections (a) and (c) of the Rule "also" outlaw fraudulent schemes and courses of conduct. *Id.* at 1400.

In *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 676 F. Supp. 458, 467-70 (S.D.N.Y. 1987), Morgan Stanley's liability did not depend on whether it "certified or made other public representations about a corporation's allegedly misleading statements"; rather its "alleged role in knowingly or recklessly preparing the projections could constitute the employment of a 'device, scheme, or artifice to defraud' in violation of 10b-5(1) or an 'act, practice, or course of business which operates or would operate as a fraud or deceit upon any person' in violation of 10b-5(3)."

[45] *Aaron*, 446 U.S. at 696 n.13 ("Webster's International Dictionary (2d ed. 1934) defines ... 'scheme' as 'a plan or program of something to be done; an enterprise; a project; as a business ***scheme*** [,or a] crafty, unethical project ...."). To "scheme" is "[t]o form plans or designs; to devise intrigue." *Webster's International Dictionary* 2234 (2d ed. 1934). *The Oxford English Dictionary* 616 (2d ed. 1989) defines "scheme": "A plan, design; a programme of action .... Hence, [a] plan of action devised in order to attain some end; a purpose together with a system of measures contrived for its accomplishment; a project, enterprise." *Black's Law Dictionary* 1344 (6th ed. 1990) defines "scheme": "A design or plan formed to accomplish some purpose; a system."

causing securities to trade at fraudulently inflated prices.[46] When §10(b) was enacted, such conduct already was an unlawful "scheme to defraud" under the mail fraud statute, and today it is called a "fraud-on-the-market" that is actionable under §10(b). *See Basic*, 485 U.S. at 241-47; *Lipton v. Documation, Inc.*, 734 F.2d 740, 744-47 (11th Cir. 1984). Every person who intentionally engages in a "scheme" to defraud is thus ***a primary violator*** of Rule 10b-5 and §10(b).

In *Affiliated Ute Citizens*, the Court observed that "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact," 406 U.S. at 152-53, but held that "[t]he first and third subparagraphs are not so restricted." *Id.* at 153. It held that the defendants violated Rule 10b-5 when they participated in ***"a 'course of business' or a 'device, scheme, or artifice' that operated as a fraud" – even though these defendants had never themselves said anything that was false or misleading***. *Id.* ***"Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures.'"*** *Competitive Assocs.*, 516 F.2d at 814. "Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws." *Id.*

Subsections (a) and (c) of Rule 10b-5 thus are aimed at "broader schemes of securities fraud" than are necessarily embodied in a single misleading statement or document, and the "'classic' fraud on the market case [which] ***arises out of transactions on an open and developed market" easily fits within the expansive language of Rule 10b-5(a) and (c)***. *Lipton*, 734 F.2d at 744, 745-47. Thus, the Fifth Circuit sitting *en banc* held that a defendant who did not himself make the statements in a misleading Offering Circular could be held primarily liable ***as a participant in a larger scheme to defraud of which that Offering Circular was only a part: "Rather than containing the entire fraud, the Offering Circular was assertedly only one step in the course of an elaborate scheme***." *Shores*, 647 F.2d at 468.

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[46] In *Harris v. United States*, 48 F.2d 771 (9th Cir. 1931), for example, "[t]he fraudulent scheme charged ... was one for the sale of [a mining company's] corporate stock ... by the manipulation of the price of the stock on the [stock exchanges] and the circulation of false reports concerning the mine through the mails." *Id.* at 774. "In fact, the whole scheme centered around the establishment of an alleged stock exchange value which is in fact wholly fictitious." *Id.* at 775.

In *Cooper*, 137 F.3d 616, plaintiffs sued Merisel, its officers and directors, its accountants, Deloitte & Touche ***and Lehman Brothers and Robinson-Humphrey, investment banks which served as underwriters of Merisel's public offerings and issued analysts' reports on Merisel.*** The complaint alleged that "'defendants falsely presented the Company's current and future business prospects and prolonged the illusion of revenue and earnings growth by making it appear that the Company's revenue and earnings growth was strong and would continue.'" *Id.* at 620.

Defendants argued that "plaintiffs cannot allege a 'scheme' to defraud, because ***those are conspiracy allegations foreclosed by Central Bank.***" *Id.* at 624. However, the Ninth Circuit rejected this argument, stating that the complaint "alleges a 'scheme' in which Merisel and the other defendants directly participated, tracking the language of ***Rule 10b-5(a), which makes it unlawful for any person 'to employ any device, scheme, or artifice to defraud.***'" *Id.* Moreover, "Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant ***committed a manipulative or deceptive act in furtherance of the scheme.***" *Id.* Furthermore,

> "[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. ***Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) ... may be liable as a primary violator under 10b-5*** .... In any complex securities fraud, moreover, there are likely to be multiple violators ...."

Id. at 624-25.

In *First Jersey*, 101 F.3d 1450, a top First Jersey corporate official who had not made any false statement claimed he should not be held liable under §10(b) of the 1934 Act for an extensive violation of §10(b) and Rule 10b-5 by First Jersey. The Second Circuit stated:

> Brennan contends that even if First Jersey committed fraud, he should not have been held personally liable for any violation ... as a primary violator of the securities law....
>
> 1. Primary Liability
>
> "Any person or entity ... who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under [federal securities law], assuming all of the requirements for primary liability ... are met." *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191, 128 L. Ed. 2d 119, 114 S. Ct. 1439 (1994) (emphasis omitted). ***Primary liability may be imposed "not only on persons who made fraudulent***

> ***misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration***." *Azrielli v. Cohen Law Offices*, 21 F. 3d 512, 517 (2d Cir. 1994).
>
> ***The evidence presented at trial sufficed to establish that Brennan had knowledge of First Jersey's frauds and participated in the fraudulent scheme.***
>
> * * *
>
> In light of the evidence presented at trial with regard to Brennan's hands-on involvement in the pertinent decisions, we conclude that the trial court did not err in finding that Brennan ***knowingly participated in First Jersey's illegal activity and that he should be held primarily liable for its violations of the securities laws***.

Id. at 1471-72.

And, in fact, many courts have upheld complaints against banks in §10(b)/Rule 10b-5 cases where, as here, false statements, manipulative or deceptive devices, contrivances and acts, and participation in a scheme to defraud have been alleged with sufficient particularity.

In *Cooper*, 137 F.3d at 628, the court held scheme liability had survived *Central Bank* and specifically noted that allegations that the investment banks named as defendants there had knowingly issued false analysts' reports and had "***access to inside information***" set them apart from other analysts who had issued favorable reports on the issuer during the Class Period and stated a valid §10(b)/Rule 10b-5 claim.

> Lehman Brothers also made specific forecasts.... Although the complaint quotes other analysts who made similar positive statements about [the company's] current status and future prospects, this does not mean that the Lehman Brothers and Robinson-Humphrey analysts' statements are somehow automatically reasonable. All the analysts wrote optimistic reports based in part on information from [the company]; ***only Robinson-Humphrey and Lehman Brothers are alleged to have known better through their access to inside information***.
>
> Even the analysts' optimistic statements can be actionable if not genuinely and reasonably believed, or if the speaker is aware of undisclosed facts that tend seriously to undermine the statement's accuracy.... The complaint alleges that the analysts were aware of undisclosed facts that showed there was no reasonable basis for their forecasts, which they did not genuinely believe.

Id. at 629. These false analysts' reports were misleading and deceptive acts and part of the fraudulent scheme. When the banks in *Cooper* claimed the so-called "Chinese Wall" shielded them from liability, the Ninth Circuit rejected this assertion:

> [Defendant investment banks] Robinson-Humphrey and Lehman Brothers assert that they followed SEC rules which prevent the sharing of inside information within their companies. 15 U.S.C. §78o(f) requires registered brokers or dealers to create and enforce "written policies and procedures reasonably designed ... to prevent

> the misuse ... of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer," and authorizes the SEC to create rules for such policies. ***If Robinson-Humphrey and Lehman Brothers have established such policies and followed them in this case, they may raise that as a defense. The existence of such policies does not, however, preclude plaintiffs from asserting in their complaint that inside information was misused.***

Id. at 628-29. The court said that the Chinese Wall might later be used as a defense, but, the court said, such an assertion (a factual issue) was ***not*** a defense at the motion to dismiss stage.

In *Murphy v. Hollywood Entm't Corp.*, 1996 U.S. Dist. LEXIS 22207, and *Flecker v. Hollywood Entm't Corp.*, 1997 U.S. Dist. LEXIS 5329, the court refused to dismiss a complaint against investment bankers and then later refused to grant summary judgment to those banks, stating that their "***roles as analysts, investment bankers and business advisors with extensive contacts with [issuer] defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a triable primary liability claim under §10(b).***" *Id.* at *25. In initially denying the bank's motion to dismiss, the court recognized that "***any person or entity who directly participates in an alleged violation of §10(b), even if that person falls within the category of professionals usually deemed 'collateral' participants, may still be liable as a 'primary violator' under §10(b).***" *Id.* at *20-*21. The court concluded:

> As for the Underwriters' role in the alleged fraud, plaintiffs do not allege the existence of any contemporaneous "smoking gun" type of documents which would demonstrate that the Underwriter defendants knew they were selling a landfill when they sold Hollywood securities. However, plaintiffs do allege that the underwriter defendants had a "***close association" with Hollywood which gave them "constant access" to the individual Hollywood defendants and all relevant, non-public information about the company. Plaintiffs further allege that the underwriter defendants were "direct participants" in the alleged wrongdoing by their role in coordinating the offering, drafting disputed offering documents and conducting a due diligence investigation. This is sufficient to bring the complaint within the scope of allegations similar to those sustained by the Ninth Circuit in Software Toolworks***.... Plaintiffs' claims are not limited to accounting fraud and thus, the underwriters' claimed reliance upon certified accounting statements does not bar the maintenance of plaintiffs' claims under 10(b). ***Further, whether the underwriters' reliance upon expertised portions of the financial statements was reasonable as a matter of law is an issue best addressed on summary judgment***....

Murphy, 1996 U.S. Dist. LEXIS 22207, at *21-*23 (footnote omitted).

In later denying summary judgment, the court noted that the defendants' motive included a "***desire to keep the stock price above $ 25.50 to avoid having to redeem***" certain shares previously issued in a corporate transaction and that the investment banks "***stood to accrue significant fees.***"

Flecker, 1997 U.S. Dist. LEXIS 5329, at *14. The *Flecker* court stated that "primary liability extends to all who make assertions' in a manner reasonably calculated to influence the investing public'" (*id.* at *23) and then denied summary judgment because:

> [T]he underwriters ... had long standing close connections to Hollywood such that they either knew or should have known that historical revenues were misstated due to changes in the same store sales base, and that revenue projections were ill-founded given the company's earnings track record as influenced by accounting changes which had the effect of adding revenue to Hollywood's balance sheets and prior earnings per share dividends.
>
> * * *
>
> Based on the foregoing, I find that defendants' roles as analysts, investment bankers and business advisors with extensive contacts with Hollywood defendants, superior access to non-public information and participation in both drafting and decision-making is sufficient to establish a triable primary liability claim under § 10(b).

Id. at *20, *25.

Livent, 174 F. Supp. 2d 144, shows that a valid §10(b)/Rule 10b-5 claim has been alleged here. In *Livent*, purchasers of Livent securities sued Livent's investment bank (CIBC) for violations of 1933 Act §11 and 1934 Act §10(b)/Rule 10b-5. The court held plaintiffs' §11 claims sufficient under a Rule 8 non-fraud pleading standard. The court also sustained the adequacy of the §10(b)/Rule 10b-5 claims – finding the bank's participation in "Livent's fraudulent scheme" was adequately pleaded. The key allegation against CIBC was that CIBC allegedly made a $4.6 million payment to Livent in return for theatrical royalties, which in reality was a secret "bridge" loan, as CIBC had a side agreement from Livent to repurchase the $4.6 million advance in six months for $4.6 million, plus interest – the "CIBC Wood Gundy Agreement." This was a fraudulent contrivance because Livent recorded income on the transaction, but did not record the loan. The district court held:

> It does not require an unreasonable inferential leap to conclude, as the Noteholders suggest, that in entering into the bridge loan transaction and secret side agreements with Livent, CIBC, as Livent's investment bankers since 1993, had acquired substantial knowledge of Livent's real financial condition and was aware of Livent's reasons to account for the $ 4.6 million "non-refundable fee" as a revenue-generating investment rather than a repayable loan....
>
> Significantly, according to the complaint, the proceeds from the alleged fraudulent arrangement were reported by Livent as current revenue in its accounts and public registration statements in order [to] [sic] create a false financial basis to reinforce and

ensure the success of Livent securities issues intended in part to repay Livent's substantial debt to CIBC.

From these allegations, ***it is fair to infer that in entering into the CIBC Wood Gundy Agreement, CIBC was aware not only that Livent contemplated marketing securities on the basis of public representations of its financial condition that Livent knew to be false, but that CIBC itself subsequently undertook to solicit and sell the very securities whose value incorporated and was affected by the falsehood CIBC itself had conceived with Livent. In this manner, CIBC's participation in Livent's fraudulent scheme went beyond a passive capacity as Livent's investment banker and financial adviser.***

* * *

The Noteholders have pled facts suggesting that CIBC became part and parcel of Livent's misleading statements by entering into a loan transaction whose true character and financial implications it agreed not to disclose. This financial interest and complicity not only assisted Livent in concealing critical information, it also committed CIBC to similarly withhold the truth from investors with whom it dealt in Livent securities, a commitment that effectively conflicted with any applicable duty CIBC had to disclose material facts in connection with subsequent public sales of such securities affected by the transaction.

Rather than generally reflecting the profit motive of any securities dealer, the concrete benefit derived by CIBC from Livent's fraud alleged here was uniquely personal to CIBC in several ways. Only CIBC, as Livent's investment bankers since 1993, is alleged to have had a longstanding, intimate relationship with Livent executives that offered it uncommon opportunity to know of, and play an active role in Livent's, financial affairs. And only CIBC is accused, in furtherance of its own motives, of assisting Livent in structuring and keeping secret the misrepresented CIBC Wood Gundy Agreement. Later, in publicly marketing Livent securities whose value partly depended on the true nature of that agreement, CIBC stood to realize gains particular to it. Beyond the standard fees and commissions associated with any investment bank's sales of securities, CIBC had a higher stake in Livent's public financings. It uniquely benefitted from the application of the proceeds of the Notes sales to Livent's considerable debt to CIBC.

Id. at 151-54.

Similarly, in *Cascade*, 840 F. Supp. 1558, the court found that allegations that a securities broker ignored red flags presented a sufficient showing of recklessness to constitute scienter. According to the complaint, the broker, Raymond James, continued to recommend Cascade's stock, ignoring red flags that had been raised, while its

> "reports and statements with respect to [the company], while purporting to be disinterested and objective professional investment analyses, based on in-depth current research, were in reality substantially false and misleading sales brochures which made exaggerated predictions based on unverified and unsupported information for which Raymond James knew, or should have known, it had no reasonable basis."

Id. at 1578. Based on the broker's alleged disregard of red flags, the court held the complaint sufficiently pleaded scienter. "These allegations, if true, may evince severe recklessness or proof of knowing misconduct." *Id.*

Finally, in *Bre-X-Minerals*, 2001 U.S. Dist. LEXIS 4571, the court denied the motion to dismiss by J.P. Morgan based on allegations it participated in a scheme to violate §10(b) and Rule 10b-5 in connection with the securities fraud involving Bre-X. In *Bre-X Minerals*, plaintiffs alleged involvement of J.P. Morgan in assisting Bre-X in structuring fraudulent business transactions, acting as Bre-X's financial advisor, and issuing false analysts' reports – ignoring "red flags" that Bre-X's claimed assets were falsified. Thus, J.P. Morgan's motion to dismiss was denied.[47]

The CC in this action pleads more wrongful conduct by CitiGroup vis-à-vis the fraudulent scheme involving Enron and with more specificity than was pleaded in any of the above cases where complaints naming banks as defendants in §10(b)/Rule 10b-5 actions were upheld.

CitiGroup cannot escape liability by claiming that the illicit SPEs and contrived transactions detailed in the CC do not meet the technical definition of a "manipulative device." It is of no moment that certain cases, purportedly building on *Santa Fe*, 430 U.S. 462, appear to have expressly read into §10(b)'s manipulation language a limited and restrictive Congressional intent to simply prohibit such "practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself." *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979); *see also Schreiber v. Burlington N., Inc.*, 568 F. Supp. 197 (D. Del. 1983), *aff'd*, 731 F.2d 163 (3d Cir. 1984); *In re Commonwealth Oil/Tesoro Petroleum Sec. Litig.*, 484 F. Supp. 253 (W.D. Tex. 1979). ***First***, whether or not the SPEs and transactions are technically "market manipulation" devices is academic even under these very cases. The SPE

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[47] *See also U.S. Envtl.*, 155 F.3d at 112 (while there is no aiding and abetting, where complaint properly alleged defendant to be primary violator because he "'***participated in the fraudulent scheme***,'" noting "***lawyers, accountants, and banks who engage in fraudulent or deceptive*** practices at their client's direction [are] a primary violator"); *Scholnick*, 752 F. Supp. at 1323 & n.9 ("bank ... may still be held liable under Rule 10b-5(a) and 10b-5(c) as a participant in the allegedly fraudulent scheme" and "allegations that Continental was directly involved in perpetrating a fraudulent scheme distinguish" case from situation where bank was only engaging in a "'routine commercial financing transaction'").

transactions have been pleaded as both contrivances and deceptive devices – and each was clearly deceptive for they falsified Enron's financial condition – thereby allowing for Rule 10b-5 scheme liability to attach. *See, e.g., Hundahl*, 465 F. Supp. at 1360 ("Few efforts to play with the price of a traded stock can be successful without running afoul of section 10(b)'s other weapon deception.").[48] ***Second***, *Santa Fe* is not so restrictive as defendants and certain courts would make it seem. Indeed, the Court clearly expressed its approval of reading the manipulation language of §10(b) broadly by stating: "No doubt Congress meant to prohibit ***the full range of ingenious devices*** that might be used to manipulate securities prices." *Santa Fe*, 430 U.S. at 477.[49] ***Third***, *Santa Fe*, *Hundahl*, *Schreiber* and *Commonwealth Oil/Tesoro* are all clearly off-point because each case really involved what was merely a state law breach of fiduciary duty cause of action, stemming from a corporate merger or acquisition, dressed up in ill-fitting federal securities law garb.[50] This case is not a mere mismanagement or breach of fiduciary duty case. Without question, it is properly before the Court as a federal securities action alleging fraud and deception. No one could plausibly suggest otherwise.

In finding the complaint in *Landry's* did not adequately plead a §10(b) claim against the defendant investment banks there, this Court stated:

> Plaintiffs have generally alleged without any particularity that the Underwriters also conducted a comprehensive due diligence investigation into Landry's operations and

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[48] Liability under §10(b) and Rule 10b-5 may be imposed for actions either manipulative or deceptive. *See, e.g. , Cooper*, 137 F.3d at 624 (Each defendant is a primary actor liable under §10(b) "as long as each defendant committed a ***manipulative*** or ***deceptive*** act in furtherance of the ***scheme***.").

[49] *See also id.* at 475 ("Those cases forcefully reflect the principle that '[§]10(b) must be read flexibly, ***not technically and restrictively***' and that the statute provides a cause of action for any plaintiff who suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities ....").

[50] *See, e.g., Santa Fe*, 430 U.S. at 480 ("There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of §10(b) and Rule 10b-5 ...."); *Schreiber*, 568 F. Supp. at 205 ("This case is the perfect example of a plaintiff, who may have nonfrivolous claims based on state law for breach of contract, tortious interference with contract, breach of fiduciary duties and perhaps even conspiracy, attempting to characterize those state law claims as violations of the federal securities laws."); *Commonwealth Oil/Tesoro*, 484 F. Supp. at 259 (plaintiffs bringing additional claims for "breach of fiduciary duty" stemming from merger activities); *Hundahl*, 465 F. Supp. at 1362 ("[F]ederalism supports this court's definition of manipulation. The court in Santa Fe stated its reluctance to imply a federal cause of action for a claim 'traditionally relegated to state law....'" "[T]he acts of which plaintiffs complain ... are classic breaches of fiduciary duty.").

> future prospects in connection with the secondary offering, for which they helped prepare the Registration Statement and Prospectus. They purportedly had access to confidential corporate information and communicated frequently with Fertitta and West about the business, but Plaintiffs fail to provide any details or identify specifically what kind of information, when it was conveyed, by whom and to whom. Plaintiffs have failed to identify any specific information communicated by document or conversations to the Underwriter Defendants or uncovered by them in their due diligence investigation. Instead they have made general statements that might give rise to speculation, but not particularized facts giving rise to a strong inference that the Underwriters acted with severe recklessness or knowingly to support allegations of fraud under the Exchange Act.

Landry's, slip op. at 66. Obviously, the allegations against CitiGroup in this case are much more detailed than those found wanting in *Landry's*. The specifics regarding (i) CitiGroup's pre-funding of LJM2 in 12/99 to enable it to engage in four non-arm's-length fraudulent transactions to artificially boost its earnings and hide debt at year-end 99; (ii) CitiGroup's ongoing funding of LJM2 in 00-01 and its administration of LJM2's affairs during 00-01 as it was used to loot Enron while falsifying Enron's reported profits by hundreds of millions of dollars while hiding billions of dollars of debt; and (iii) the huge ($2.4 billion) Delta transactions to artificially boost Enron's reported profits hid billions in loans to Enron ***and*** CitiGroup's extensive and continuous ***commercial*** lending and investment banking relationship between CitiGroup and Enron, distinguishes the pleading here from the 10b-5 claim one found wanting in *Landry's*. Here, CitiGroup took numerous affirmative steps to falsify Enron's financial results and further the fraudulent scheme and course of business, while it achieved direct financial benefits from the fraud. Nothing even remotely approaching this was alleged in *Landry's*.

V. CITIGROUP MADE FALSE AND MISLEADING STATEMENTS IN REGISTRATION STATEMENTS AND ANALYSTS REPORTS

CitiGroup admits that its analysts issued statements concerning Enron during the Class Period. Mot. at 32. None of the cases cited by CitiGroup hold that investment banks cannot (or even should not) be liable for statements of their analysts. Indeed, CitiGroup would have to disavow it issued analyst reports (among other things) to give any meaning to the cases CitiGroup cites at pages 45-47 of its Motion. CitiGroup does ***not*** do that. Nor do any of the cases CitiGroup cites support the suggestion that it cannot be liable for concealing its $2.4 billion in disguised loans to Enron (the Delta transactions).

Contrary to CitiGroup's claim that the CC does not specify which false statements are attributed to CitiGroup, the CC does exactly that and in great detail.

First of all, CitiGroup made numerous false statements in 18 analysts' reports issued during the Class Period. At the outset of the Class Period, Enron's stock was performing poorly – no better than the stock of companies in its "peer index." To help push Enron stock higher, CitiGroup began to issue very positive reports on Enron. On 10/22/98, CitiGroup issued a report on Enron, which rated Enron a "***Buy***" and stated:

> Wholesale energy operations ... continued to be the largest contributor to earnings. IBIT was $277 million versus $173 million in last year's third quarter. ***The strength of the wholesale energy commodity and asset portfolios resulted in excellent earnings***.
>
> * * *
>
> ... The third quarter was an excellent period for ... [a] new [Enron Energy Services (EES)] business. EES contracts for customers ... of $850 million in the third quarter, including several large contracts ....

¶123.

On 1/27/99, CitiGroup issued a report on Enron, stating:

> EES .... Outsourcing is experiencing a strong market reception, ***much stronger than ENE had anticipated. Contracting results were strong***. During 1998, ENE entered into $3.8 billion of new contracts. Now, ENE is convinced that EES will be profitable by the fourth quarter of 1999. ***EES has a product to sell and is selling extremely well***.

¶133.

By early 99, Enron stock was moving higher, outperforming its peer index, in part due to these very positive CitiGroup reports. The statements made in the two CitiGroup analysts' reports issued between 10/22/98-1/27/99, were false or misleading. The true but concealed facts were:

(a) Enron generated hundreds of millions of dollars of profits and transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled for which Enron had guaranteed loans to the SPEs.

(b) The results of Enron's WEOS business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. ***First***, by phony or illusory hedging transactions with entities that were not independent of Enron. ***Second***, by the abuse

of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And ***third***, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve."

(c) EES had entered into many contracts on which it would lose hundreds of millions of dollars. To induce customers to enter into these agreements – so that Enron could claim its EES business was growing and succeeding – Enron had, in effect, "purchased" their participation by promising them unrealistic savings and charging low prices that would likely result in a loss.

(d) The value of contracts entered into by EES was grossly overstated by the misuse and abuse of mark-to-market accounting to create huge current-period values on what were, in fact, highly speculative long-term contracts on which Enron was almost certain to lose money. This resulted in EES improperly and prematurely recognizing hundreds of millions of dollars of revenue that not only boosted its financial results, but allowed top EES managers and executives to collect huge bonuses based on these improperly inflated contract valuations.

(e) It was impossible for EES to enter into energy contracts that extended beyond three years and accurately account for energy costs or savings because of the variables related to these contracts. Enron misused these variables in long-term contracts to manipulate its assumptions – moving the earnings curve to create larger contract values and record higher revenues abusing mark-to-market accounting.

(f) Enron was not successfully managings balance sheet and financial risk by effectively hedging its merchant investments and placing billions of dollars of non-recourse debt in related but independent parties. In fact, the hedges were illusory, not real, and were largely dependent on the value of Enron's own stock where Enron still was exposed to the risk of its merchant investments. This was an extraordinarily dangerous situation for Enron because, in fact, based upon its true financial condition, which was known to its insiders, Enron did not deserve the investment grade credit rating it was carrying and it was in constant and precarious danger of losing that rating when the true structure of its off-balance-sheet partnerships and SPEs became known and its true financial condition was revealed. ¶155.

During the balance of 99, Enron's stock continued to outperform its "peer index," as CitiGroup continued to push Enron stock. On 7/20/99, CitiGroup issued a report rating Enron a "***Buy***" and stated:

> Enron reported a significant increase in second quarter earnings. Earnings rose 29.6% to $[0.27] per diluted share versus $[0.21] the second quarter of 1998. Net income increased 53.1% to $222 million up from $145 million.
>
> * * *
>
> Relative to retail energy services, it was a good quarter.... [It] is on track to break-even in the fourth quarter of 1999.

¶163.

On 8/20/99, CitiGroup issued a report on Enron, rating Enron a "***Buy***." It stated:

> [W]e increased our 1999 earnings estimate to $1.20 from $1.15 per share to reflect the strength of Enron's growing communications business.... [W]e are increasing our 12-month price target.

¶166.

On 9/20/99, CitiGroup issued a report on Enron, rating Enron a "***Buy***" and stated:

> [T]here is ... ***is a high probability that Enron can be a solid double-digit grower***....
>
> ... Enron is the majority owner of Dabhol Power Co.... Maharashtra Pradesh Congress Committee has indicated that it wants to ... re-negotiate Phase I because it is affecting Maharashtra's industrial growth. ***However, Enron is confident that it might work with any political party to apply the project***.... Enron has established optimistic relationships in the country and is convinced that it can work with several political parties in power.

¶169.

On 10/20/99 CitiGroup issued a report on Enron. It rated Enron a "***Buy***" and forecast 00 EPS of $1.40 and also stated:

> Enron Corp. had a 12.5% increase in recurring earnings per diluted share to $0.27 versus $0.24 in 1998. [N]et income increased 73% ... to $290 million, up from $168 million the previous year....
>
> Wholesale Energy Operations and Services are continuing to be the most principal contributor of earnings, a quickly growing element of the company. During the third quarter, the Wholesale Group produced IBIT of $378 million – a 36.5% increase over the $277 million last year.
>
> * * *
>
> Enron Energy Services (EES) reported the best quarterly results since the beginning of the business.... ENE contracted $2.5 billion of customer's future expenditures for

> energy and services compared to $850 million a year ago. This quarter's results included the largest outsourced contract signed to date, a 10-year outsource agreement with Owens Corning ....

¶186.

The statements made in the four CitiGroup analysts' reports issued between 7/20/99-10/20/99, were false or misleading when issued. The true but concealed facts were:

(a) Enron's financial statements and results issued during this period were false and misleading as they inflated Enron's revenues, earnings, assets, and equity and concealed billions of dollars of debt that should have been shown on Enron's balance sheet, as described in ¶¶418-611.

(b) Enron's financial condition, including its liquidity and credit standing, was not nearly as strong as represented, as Enron was concealing billions of dollars of debt that should have been reported on its balance sheet – and which would have very negatively affected its credit rating, financial condition and liquidity – by improperly transferring that debt to the balance sheets of various non-qualifying SPEs and partnerships it controlled, as detailed herein.

(c) Enron generated hundreds of millions of dollars of profits and improperly transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled.

(d) The results of Enron's WEOS business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. ***First***, by phony or illusory hedging transactions with entities that were not independent of Enron. ***Second***, by the abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And ***third***, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve." "Moving the curve" was "***endemic***" inside Enron – done in all of Enron's commodity-trading activities – everything Enron traded.

(e) The financial performance and the value of contracts entered into by EES were grossly overstated through various techniques, including the misuse and abuse of mark-to-market accounting to create huge current-period values for Enron on what were, in fact, highly speculative and indeterminate outcomes of long-term contracts. This resulted in EES improperly and

prematurely recognizing hundreds of millions of dollars of revenue that not only boosted its financial results, but allowed top EES managers and executives to collect huge bonuses based on these improperly inflated contract valuations.

(f) EES was, in fact, losing hundreds of millions of dollars on many of its retail energy contracts. To induce customers to enter into these agreements – so that Enron could claim its EES business was growing and succeeding – Enron had, in effect, "purchased" their participation by promising them unrealistic savings, charging low prices that would result in a loss, spending millions of dollars in the short term to purchase purportedly more energy-efficient equipment. Enron would lose money on the EES deals, but had to make them more and more attractive to generate new clients, while the Company utilized unrealistic projections and mark-to-market accounting to mislead investors into believing that the EES contracts were making money.

(g) Enron's Dabhol power plant in India was a financial disaster where Enron was losing millions. Dabhol never generated profits for Enron or benefitted its business or financial condition and resulted in a huge loss for Enron.

(h) Enron was not successfully managing its balance sheet by effectively hedging its merchant investments and placing billions of dollars of non-recourse debt in related but independent parties. In fact, the hedges were illusory, not real and were largely dependent on the value of Enron's own stock where Enron still was exposed to the risk of its merchant investments. This was an extraordinarily dangerous situation for Enron because, in fact, based upon its true financial condition, which was known to its insiders, Enron did not deserve the investment grade credit rating it was carrying and it was in constant and precarious danger of losing that rating when the true structure of its off-balance-sheet partnerships and SPEs became known and its true financial condition was revealed.

(i) As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's wholesale and retail energy operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because

neither of those businesses had the current strengths or success to justify the forecasts and claims of future growth that were being made.

(j) As a result of the foregoing, the revenue and EPS forecasts being made for Enron going forward were also grossly false because historical earnings, upon which those forecasts were based, were falsified and the result of improper accounting manipulation. In truth, Enron's various business operations not only had huge concealed losses that would have to be recognized and would very adversely impact Enron's financial results, but those core business operations simply did not have the strength or success necessary for them to generate anywhere near the kind of revenue and profit growth being forecast for them. ¶214.

Between 4/00 and 7/00 CitiGroup issued very strong reports on Enron that helped push Enron stock to its all-time high of $90-3/4 in 8/00. On 4/12/00, CitiGroup issued a report on Enron. It rated Enron a "***Buy***" and forecast 00 and 01 EPS of $1.43 and $1.70 and a 20% five-year EPS growth rate for Enron. It also stated:

> THE BANDWIDTH OPPORTUNITY
>
> ENE has already done about a dozen trades since announcing its first trade with Global Crossing in December 1999; we expect the further commercialization of this market should provide a visible catalyst to ENE's share price in 2000.

¶227.

On 7/19/00, CitiGroup issued a report on Enron. It rated Enron a "***Buy***," with a $100 price target and forecast 00 and 01 EPS of $1.43 and $1.70 and a 20% EPS growth rate for Enron. It also stated:

> ***Maintain ... rating on Enron following announcement of a 20-year exclusive agreement to deliver Blockbuster Video's entire movie library to customers over broadband networks***.... Enron plans to roll out the service in two test medium-sized test cities around year-end, with roll out to several more cities in 2001.
>
> ... ***We consider this to be a marquis announcement by Enron***. In our view, the credibility of the partners goes a long way toward ***validating the "content delivery" part of Enron's two-part telecommunications strategy (the other part is bandwidth trading)***.

¶244.

On 7/24/00, CitiGroup issued a report on Enron. It rated Enron a "***Buy***," maintained a $100 price target for the stock and forecast 00 and 01 EPS of $1.43 and $1.70 and a 20% long-term EPS growth rate for Enron. It also stated:

- ENE reported strong 2Q:00 operating EPS of $0.34 ... and above our $0.32 estimate.

- Key segment, wholesale energy up 23% .... Key driver of growth: EnronOnline, volumes up 92%, now accounting for 60% of all trades.

- ***Bandwidth beginning to show critical mass***: 50 trades with 17 counterparties. ***We expect transactions to pick up steam over the next 6-12 months***.

* * *

- Enron Energy Services (retail energy) ***profit growth continues***, $24M, compared with $16M in 1Q:00.

- ***We maintain our estimates and reiterate our "Buy" rated on ENE***.

* * *

Broadband Services

In our view, Enron Broadband Services is the key new value creation driver for the company. Management revealed that since the beginning of the year, ***EBS has made over 50 standardized transactions with 17 different counterparties*** .... [T]hese numbers are ahead of our expectations. ***In our view, these numbers validate the credibility in this important new market, whose ultimate value could exceed the energy commodity market within 5 years***. We expect transactions to pick up steam from this level over the next 6-12 months.

* * *

On the content delivery side (the other half of Enron's bandwidth strategy), Enron executed $19 million in content delivery service contracts in the quarter, including a 20-year exclusive agreement with Blockbuster to stream on-demand movies over Enron's network.... ***[W]e consider this a marquee contract, highlighting the viability of Enron's content delivery platform, and, incidentally we think this will attract new investors to Enron's stock***. As part of the effort in content delivery, Enron continues the development of its own network. To date, 5,325 miles of Enron's fiber-optic network are complete, with another 9,175 miles expected to be finished by the end of the year.

¶249.

In 9/00, Enron's stock began to decline from its all-time high and pierced the first equity trigger issuance price in the LJM2/SPE deals, which CitiGroup was funding and administering.

CitiGroup moved to "defend" the stock, *i.e.*, to help support it and stem its decline. On 9/21/00, CitiGroup issued a report on Enron which stated:

Mark-To-Market Brouhaha; Buy Energy Marketers

- Recent press has questioned accounting practices of energy marketers. Concerns center on use of "mark-to-market" accounting

* * *

- ***View concerns as unfounded***

* * *

- ***Reiterate [Buy] rating on Enron*** ...

Concerns over accounting practices appear to have driven down the share prices of energy marketers .... ***We see these concerns as unfounded.*** Mark-to-market accounting is standard industry practice that actually reduces risk and provides a more accurate earnings picture than the use of cash or accrual accounting, in our view. ***Recommend purchase on share price weakness of ENE*** ....

¶259.

On 10/18/00, CitiGroup issued a report on Enron. It rated Enron a "***Buy***," with a $100 price target, and forecast 00 and 01 EPS of $1.43 and $1.70 and a 20% long-term EPS growth rate for Enron. It also stated:

- Impressive wholesale energy results dominate earnings ....

* * *

- Other segments solid: Retail Energy, $30 million in operating income, in line sequential growth from $24 million in 2Q:00. $4.1 billion in new contracts, on track to hit $16 billion full year goal.

- Bandwidth trading continues to build traction ....

- ***Reiterate our "Buy" rating on ENE; and 12-month price target of $100.***

* * *

... New contracting volumes of $4.1 billion in the quarter vs. $2.5 billion last year keep Enron on track to hit its $16 billion goal for the year in new contract volumes. ***Increasingly, we see [EES] as a significant contributor to earnings growth in the "out" years of our 2000-2005 earnings forecast .... We continue to expect significant sequential as well as year-over-year growth in Retail Energy.***

* * *

... ***[S]trong sequential ramp in transactions further validates the bandwidth commodity market .... We continue to expect transactions to pick up steam from this level over the next 6-12 months....***

Elements for continued growth in bandwidth trading are in place.

¶267.

The statements made in the five CitiGroup analysts' reports issued between 4/12/00-10/18/00, were false or misleading when issued. The true but concealed facts were:

(a) Enron's financial statements and results issued during this period were false and misleading as they inflated Enron's revenues, earnings, assets and equity and concealed billions of dollars of debt that should have been shown on Enron's balance sheet, as described in ¶¶418-611.

(b) Enron's financial condition, including its liquidity and credit standing, was not nearly as strong as represented, as Enron was concealing billions of dollars of debt that should have been reported on its balance sheet – and which would have very negatively affected its credit rating, financial condition and liquidity – by improperly transferring that debt to the balance sheets of various non-qualifying SPEs and partnerships it controlled.

(c) Enron generated hundreds of millions of dollars of profits and improperly transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled.

(d) The results of Enron's WEOS business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. ***First***, by phony or illusory hedging transactions with entities that were not independent of Enron. ***Second***, by the abuse of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And ***third***, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "moving the curve." Curve manipulations occurred in every quarter in all of Enron's WEOS operation.

(e) The financial performance and the value of contracts entered into by EES were grossly overstated through various techniques, including the misuse and abuse of mark-to-market accounting to create huge current-period values for Enron on what were, in fact, highly speculative and indeterminate outcomes of long-term contracts. This resulted in EES improperly and prematurely recognizing hundreds of millions of dollars of revenue that not only boosted its financial

results, but allowed top EES managers and executives to collect huge bonuses based on these improperly inflated contract valuations.

(f) EES was, in fact, losing hundreds of millions of dollars on many of its retail energy contracts. To induce customers to enter into these agreements – so that Enron could claim its EES business was growing and succeeding – Enron had, in effect, "purchased" their participation by promising them unrealistic savings, charging low prices that would result in a loss. Enron would lose money on the EES deals, but had to make them more and more attractive to generate new clients, while the Company utilized unrealistic projections and mark-to-market accounting to mislead investors into believing that the EES contracts were making money.

(g) The purported prospects for, and actual success of, Enron's EBS division was grossly overstated. ***First***, Enron's broadband network – the so-called Enron Intelligent Network or EIN – was plagued by serious and persistent technical difficulties, which prevented it from providing the type of high-speed and high-quality transmission that was indispensable to any hope of commercial success. ***Second***, Enron was encountering significant difficulties in completing the build-out of its broadband network and, as a result, did not have currently, and would not have at any reasonable time in the foreseeable future, a functioning broadband network. For instance, the EIN – the core of the Enron Broadband Operating System ("BOS") – was doomed to failure due to numerous intractable problems.

(h) To inflate the purported revenues of its EBS operations, Enron was engaging in transactions involving so-called dark fiber – unlit broadband-transmission capability – recognizing significant revenue on these transactions when, in fact, they were artificial contrivances known as "dark-fiber swaps," which involved no real economic substance, but were simply a swap of Enron's dark-fiber capacity with some counterparty for its dark-fiber capacity.

(i) Enron exacerbated the manipulative and deceptive financial impact of dark-fiber swaps by accounting for the revenue or payment it received from the counterparty that bought dark fiber from Enron ***as current-period revenue*** while, at the same time, Enron was ***capitalizing*** the amounts it paid to that party to buy dark fiber from it on the other side of the swap. Thus, Enron avoided recognizing the expense of that purchase in the current period and instead, amortized it over

many, many years – a deliberate accounting manipulation where revenue and expense were mismatched to inflate current-period results.

(j) The prospects for future revenue and profits from Enron's EBS operation and the purported value of that operation to Enron and to its stock price was completely arbitrary and without any basis in fact ***current*** problems in that business, as well as the current state of EBS business, made such revenue and profit forecasts and valuations were arbitrary, unreasonable and unobtainable.

(k) Enron's purported growth in broadband intermediation – trading bandwidth access – was neither as successful as claimed nor was the market developing as quickly or in the manner Enron asserted. Enron grossly overstated ***the number of customers or counterparties*** it was doing bandwidth intermediation with by counting as ongoing customers or trading partners entities that had done only a test or an experimental trade and not engaging in any ongoing bandwidth intermediation. Even worse, Enron grossly overstated the ***number of trades*** being conducted by its broadband intermediation to create the illusion of ever-increasing levels of activity, which it accomplished by splitting up what was, in fact, a single unified trade into five or 10 or even more separate trades, thus creating the false image of increasing trading activity.

(l) Enron was abusing and misusing mark-to-market accounting with respect to its broadband intermediation activity, utilizing this accounting method – together with false assumptions of ultimate value – to create much higher current-period revenue and bottom-line results than were reasonable and attainable had proper accounting techniques been used.

(m) The favorable impact of the Blockbuster VOD joint venture was misrepresented and overstated. ***First***, Blockbuster did not have the legal right to electronically distribute movie content – the indispensable element of a successful broadband based VOD system – in cable-quality digital format. ***Second***, due to technical problems with its broadband network, Enron could not transmit movies or other content with sufficient quality or speed to permit the VOD system to ever succeed. Notwithstanding these substantial defects – plus abuse of mark-to-market accounting – Enron discounted and recognized a wholly unrealistic projection of revenue over the entire 20-year life of the Blockbuster VOD venture into current periods, offset it by unrealistically

low expense estimates, and failed to take any proper reserve for uncertainty of outcome or collectability.

(n) Enron was not successfully managing its balance sheet by effectively hedging its merchant investments and placing billions of dollars of non-recourse debt in related but independent parties. In fact, the hedges were illusory, not real, and were largely dependent on the value of Enron's own stock where Enron still was exposed to the risk of its merchant investments. This was an extraordinarily dangerous situation for Enron because, in fact, based upon its true financial condition, which was known to its insiders, Enron did not deserve the investment grade credit rating it was carrying and it was in constant and precarious danger of losing that rating when the true structure of its off-balance-sheet partnerships and SPEs became known and its true financial condition was revealed.

(o) In fact, Enron did not deserve an investment grade credit rating and did not have a solid or substantial financial structure because it was inflating the value of its assets by billions of dollars while concealing billions of dollars of debt that should have been on its balance sheet. As a result, Enron's true financial structure was extremely fragile.

(p) As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's wholesale and retail energy operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims for future growth that were being made.

(q) As a result of the foregoing, the revenue and EPS forecasts being made for Enron going forward were also grossly false because historical earnings, upon which those forecasts were based, were falsified and the result of improper accounting manipulation. In truth, Enron's various business operations not only had huge concealed losses, which would have to be recognized

and would very adversely impact Enron's financial results, but those core business operations simply did not have the strength or success necessary for them to generate anywhere near the kind of revenue and profit growth being forecast for them. ¶300.

By mid-3/01, Enron had abandoned the Blockbuster VOD joint venture and its stock was falling sharply – piercing more equity issuance price triggers in the LJM2/SPE deals CitiGroup was funding and administering. Again, CitiGroup moved to defend the stock – to try to stem its decline and prevent the Ponzi scheme from unraveling. On 3/12/01, CitiGroup issued a report on Enron. It rated Enron a "***Buy***," with a $100 price target, and forecast 01 and 02 EPS of $1.73 and $2.05, with a 20% long-term EPS growth rate for Enron. It also stated:

> Enron announced a mutual decision to terminate their agreement with Blockbuster....
>
> ... ***[W]e still maintain our bullish view on Enron***. We are not recommending Enron because of the potential for Content Delivery.... Instead, we see three reasons for owning Enron: Wholesale (Merchant) Energy, Retail Energy, and Bandwidth Trading. The first two are actuals, while the last is a very robust potential, in our view....
>
> WHOLESALE (MERCHANT) ENERGY: KEY DELIVER FOR 3-5 YEARS
>
> First, and most important, is Wholesale Energy .... This business, which now accounts for 80% of Enron's earnings, grew at approximately 50% CAGR for the past 4 years .... ***We are projecting minimum 30% compound annual growth at this segment for the next four years***....
>
> RETAIL ENERGY IS A UNIQUE FRANCHISE, BACKING UP GROWTH IN LATER YEARS
>
> Enron Energy Services (Retail Energy) ... ***is moving ahead at a rapid pace***.... [T]he unit earned $103 million in 2000, and we project will earn more than $200 million in 2001.... ***[W]e project rapid growth from these levels, as we look towards the end of a 2001-2005 forecast period***.
>
> Enron Energy Services is a unique franchise ... ***which should support corporate earnings growth in the 20%-25% during the last several years of our 2001-2005 forecast period***.
>
> BANDWIDTH INTERMEDIATION (TRADING): PROJECT GREATER VALUE THAN ENERGY WITHIN 5 YEARS
>
> Finally, we see Bandwidth Intermediation as a key growth driver, ***whose value is likely to exceed energy within 5 years***. The "top line" growth of bandwidth, approximately 20% per year, provides significantly greater upside potential than the gas and electricity markets ... ***we see it as sustaining Enron's growth after the energy opportunity becomes fully realized***.

* * *

The growth in bandwidth transactions validates for us the potential of the bandwidth commodity market.... For the full year 2001, we expect a 5-10 fold increase in transactions, with profitability likely in 2002/2003.

BOTTOM LINE: GROWTH INTACT

Bottom line, we see the key growth drivers – Merchant Energy, Retail Energy, and Bandwidth Intermediation – as solidly intact, and providing 20%-25% annual EPS growth over the next 5 years. In fact, we project a steady rise in Enron's growth rate, as Retail Energy and Bandwidth pick up relative to Wholesale Energy (by 2004, we see Enron's corporate EPS growing at 25%, up from today's 20%).

¶304.

On 3/22/01, CitiGroup issued a report on Enron. It rated Enron's stock a "***Buy***" and forecast 01 and 02 EPS to $1.73 and $2.05 and a 20% long-term EPS growth rate for Enron. It also stated:

Enron Corporation: REAFFIRMS CONFIDENCE IN $1.70-$1.75 GUIDANCE FOR 2001 ... OUR OUTLOOK ON ENRON REMAINS STRONG

Enron this morning reaffirmed their confidence in their 2001 earnings target of $1.70 to $1.75, on the heels of yesterday's sell-off. We remain confident in Enron's ability to achieve this goal, and maintain our 2001 EPS estimate of $1.73. As we stated yesterday, we think that the sell-off was unjustified as it related to concerns over ENE bandwidth unit.... We are also not concerned about last weeks announcement of the termination of the Blockbuster deal, as we have always placed a greater value on the bandwidth trading portion of Enron's bandwidth strategy, rather than on content delivery. ***We remain confident that bandwidth trading, the key segment within ENE's bandwidth strategy, will show strong growth in 1Q and the remainder of 2001.***

¶308.

As Enron's stock continued to fall, CitiGroup continued to defend it – to support it – to try to halt the potentially fatal decline in the stock price that had now taken it below several equity issuance trigger prices in the LJM2/SPE deals CitiGroup was funding and administering. On 5/18/01, CitiGroup issued a report on Enron. It rated Enron a "***Buy***," with a $100 price target, while continuing to forecast 01 and 02 EPS of $1.80 and $2.05 and a 20% long-term EPS growth rate for Enron. It also stated:

Enron Corporation: REITERATE BUY; BELIEVE LEADERSHIP INTACT

- ... Stock price down 39% from 52-week high ($90 on August 23) vs. peer group, up 1.9%

* * *

- ***We see ENE's business fundamentals intact, and in fact, improving. Growth rate expansion to 25% from 20%; growing returns on capital; bandwidth trading all good reasons to own stock – justify premium valuation.***

¶326.

On 6/7/01, CitiGroup issued a report on Enron. It rated Enron a "***Buy***," with a $100 price target, and forecast 01 and 02 EPS of $1.80 and $2.05, with a 20% long-term EPS growth rate for Enron. It also stated:

> Enron Corporation : Reiterate Buy; Merchant Energy Fundamentals Remain Strong
>
> - We reiterate our Buy rating on ENE, in the face of the recent weakness of the stock, down 44% from 52-week high ($90 on August 23).
>
> * * *
>
> - In our view, recent weakness has been driven by factors not related to core Energy Merchant business, namely India and their broadband strategy.
>
> * * *
>
> ***Continued Concern Over Broadband Business***
>
> We continue to believe strongly in Enron's bandwidth trading strategy, and see it as a tremendous opportunity to extend their industry-leading risk management skills to the rapidly developing bandwidth commodity market. Enron's core strategy remains the management of price risk for customers, which is facilitated by their Bandwidth Intermediation (trading & marketing) group. We are not deterred by what some see as negative developments in other segments of their bandwidth efforts (*i.e.* Blockbuster deal termination in Content Delivery)....
>
> Bottom Line
>
> We reiterate our Buy rating on ENE. ***Their fundamentals not only remain intact, but are in fact growing stronger, in our view.... [W]hich we expect to drive 20% earnings growth over the next several years (expanding to 25% by 2005)***.

¶327.

On 7/13/01, CitiGroup issued a report on Enron. It rated Enron a "***Buy***" with a $75 price target. It also ***increased*** Enron's forecasted 01 and 02 EPS to $1.80 and $2.15 with a 20% long-term EPS growth rate for Enron. It also stated:

> Enron Corporation: Strong 2Q Driven by Merchant Energy, Above Expectations
>
> - ENE reported strong 2Q EPS of $0.45 ... well above our expectations ....
>
> - Merchant Energy again drove the strong results, with IBIT up 93% over last year ....

- Bandwidth trading, somewhat below expectation, still shows strong sequential growth, up 31% – 759 transactions in 2Q:01 vs. 580 in 1Q:01. Partial reason for weakness appears to be credit concerns with some telecom counterparties.

- Enron reaffirmed 2001 guid. of $1.80 and introduced 2002 guidance of $2.15. We raise our 2000 EPS estimate by $0.10 to $2.15, reflecting our continued confidence in their Merchant Energy platform.

* * *

RETAIL ENERGY SERVICES

Enron Energy Services, Enron's retail energy services IBIT increased to $60 million in 2Q:01 (in-line with our expectations) vs. $40 million in 1Q:01 and $46 million in the year ago quarter. ***It appears more likely that Enron will earn towards the upper end of our estimate range of $200-$250 million for 2001, up from $103 million in 2000 and a ($68) million start-up loss in 1999. Their official guidance is at $225 million and we think it is likely that they will come in above that number.*** We see this segment as growing increasingly important for Enron.... We expect this segment ... to grow rapidly, and be a strong source of visible earnings growth during the last half of our 2001-2005 period.

¶335.

The statements made in the five CitiGroup analysts' reports issued between 3/12/01-7/13/01, were false or misleading when issued. The true but concealed facts were:

(a) Enron's financial statements and results issued during this period were false and misleading as they inflated Enron's revenues, earnings, assets and equity and concealed billions of dollars of debt that should have been shown on Enron's balance sheet, as described in ¶¶418-611.

(b) Enron's financial condition, including its liquidity and credit standing, was not nearly as strong as represented, as Enron was concealing billions of dollars of debt that should have been reported on its balance sheet – and which would have very negatively affected its credit rating, financial condition and liquidity – by improperly transferring that debt to the balance sheets of various non-qualifying SPEs and partnerships it controlled, as detailed herein.

(c) Enron generated hundreds of millions of dollars of profits and transferred billions of dollars of debt off its balance sheet by entering into non-arm's-length transactions with SPEs and partnerships Enron controlled.

(d) The results of Enron's WEOS business – its largest business unit – were manipulated and falsified to boost its reported profitability in various ways. ***First***, by phony or illusory hedging transactions with entities that were not independent of Enron. ***Second***, by the abuse

of mark-to-market accounting by adopting unreasonable contract valuations and economic assumptions when contracts were initially entered into. And ***third***, by arbitrarily adjusting those values upward at quarter's end to boost the wholesale operation's profits for that period – a practice known inside Enron as "***moving the curve.***"

(e) The financial performance and the value of contracts entered into by EES were grossly overstated through various techniques, including the misuse and abuse of mark-to-market accounting to create huge current-period values for Enron on what were, in fact, highly speculative and indeterminate outcomes of long-term contracts. This resulted in EES improperly and prematurely recognizing hundreds of millions of dollars of revenue that not only boosted its financial results, but allowed top EES managers and executives to collect huge bonuses based on these improperly inflated contract valuations.

(f) EES was, in fact, losing hundreds of millions of dollars on many of its retail energy contracts. To induce customers to enter into these agreements – so that Enron could claim its EES business was growing and succeeding – Enron had, in effect, "purchased" their participation by promising them unrealistic savings, charging low prices that would likely result in a loss. Enron would lose money on the EES deals, but had to make them more and more attractive to generate new clients, while the Company utilized unrealistic projections and mark-to-market accounting to mislead investors into believing that the EES contracts were making money.

(g) The purported prospects for, and actual success of, Enron's EBS division was grossly overstated. ***First***, Enron's broadband network – the so-called Enron Intelligent Network or EIN – was plagued by serious and persistent technical difficulties, which prevented it from providing the type of high-speed and high-quality transmission that was indispensable to any hope of commercial success. ***Second***, Enron was encountering significant difficulties in completing the build-out of its broadband network and, as a result, did not have currently, and would not have at any reasonable time in the foreseeable future, a functioning broadband network. For instance, the EIN – the core of the Enron Broadband Operating System ("BOS") – was doomed to failure due to numerous intractable problems.

(h) To inflate the purported revenues of its EBS operations, Enron was engaging in transactions involving so-called dark fiber – unlit broadband-transmission capability – recognizing significant revenue on these transactions when, in fact, they were artificial contrivances known as "dark-fiber swaps," which involved no real economic substance, but were simply a swap of Enron's dark-fiber capacity with some counterparty for its dark-fiber capacity.

(i) Enron exacerbated the manipulative and deceptive financial impact of dark-fiber swaps by accounting for the revenue or payment it received from the counterparty that bought dark fiber from Enron ***as current-period revenue*** while, at the same time, Enron was ***capitalizing*** the amounts it paid to that party to buy dark fiber from it on the other side of the swap. Thus, Enron avoided recognizing the expense of that purchase in the current period and instead, amortized it over many, many years – a deliberate accounting manipulation where revenue and expense were mis-matched to inflate current-period results.

(j) The prospects for future revenue and profits from Enron's EBS operation and the purported value of that operation to Enron and to its stock price was completely arbitrary and without any basis in fact due to ***current*** problems in that business, making the current state of EBS business, that such revenue and profit forecasts and valuations arbitrary, unreasonable and unobtainable.

(k) Enron's purported growth in broadband intermediation – trading bandwidth access – was neither as successful as claimed nor was the market developing as quickly or in the manner Enron asserted. The number of customers or counterparties Enron was doing bandwidth intermediation with was overstated by counting as ongoing customers or trading partners entities that had done only a test or an experimental trade and not engaging in any ongoing bandwidth intermediation. Also, the ***number of trades*** being conducted by Enron's broadband intermediation was overstated to create the illusion of ever-increasing levels of activity, which it accomplished by splitting up what was, in fact, a single unified trade into five or 10 or even more separate trades, thus creating the false image of increasing trading activity.

(l) In fact, Enron did not deserve an investment grade credit rating and did not have a solid or substantial financial structure because it was inflating the value of its assets by

billions of dollars while concealing billions of dollars of debt that should have been on its balance sheet. As a result, Enron's true financial structure was extremely fragile.

(m) As a result of the foregoing, the forecasts for strong continued revenue and earnings growth for Enron's wholesale and retail energy operations were completely false, in part, because the historical financial performance and condition of those operations had been materially falsified – thus there was no real basis upon which to forecast such further growth – and because neither of those businesses had the current strengths or success to justify the forecasts and claims for future growth that were being made.

(n) As a result of the foregoing, the revenue and EPS forecasts being made by and for Enron going forward were also grossly false because historical earnings, upon which those forecasts were based, were falsified and the result of improper accounting manipulation. In truth, Enron's various business operations not only had huge concealed losses, which would have to be recognized and would very adversely impact Enron's financial results, but those core business operations simply did not have the strength or success necessary for them to generate anywhere near the kind of revenue and profit growth being forecast for them. ¶339.

On 10/16/01, Enron shocked investors by revealing huge losses and shareholder equity writedowns. Enron's stock was plunging ever lower – to levels that now threatened to collapse the house of cards. CitiGroup hung in there – still trying to support the stock price to try to stave off a complete collapse of the Ponzi scheme. On 10/16/01, CitiGroup issued a report on Enron. The report continued to rate Enron stock a "***Buy***" and to forecast 01 and 02 EPS of $1.80 and $2.15 for Enron while raising Enron's long-term EPS growth rate to 23%. It also stated:

- Enron reported 3Q recurring operating EPS of $0.43 vs. $0.34, $0.01 above our estimate.
- KEY DRIVER: Solid Americas Wholesale Service (Merchant Energy) IBIT up 31%, in-line with volume growth of 35%.
- Recurring results exclude $2.2 billion in charges associated with several under-performing non-Merchant businesses.
- Although the large size of these write-offs may initially be viewed negatively by the market, we view them as clearing the balance sheet of under-performing non-core assets which have been an overhang on the stock. ***View write-offs positively in the long-run***.

- We reiterate our 2001 and 2002 EPS estimates of $1.80 and $2.15, respectively.

* * *

Write-off of Under-Performing Non-Merchant Assets Rids Enron of Overhangs

In the third quarter, Enron took $1.01 billion in charges associated with several under-performing, non-Merchant businesses, in addition to a $1.2 billion decrease in their shareholders equity account.... Although these write-offs are significant and may be interpreted negatively at face value, ***we view them as strongly positive in the long-run, as they reflect the removal of several of the overhangs which have affected the stock.***

¶370.

On 10/19/01, CitiGroup issued a report on Enron. The report continued to rate Enron a "***Buy***" and continued to forecast 01 and 02 EPS of $1.80 and $2.15 for Enron as well as 23% long-term EPS growth rate for Enron. It also stated:

SUMMARY

- We reiterate our Buy rating on Enron after untangling part of a complicated story involving their balance sheet, cash flow and business practices.

* * *

- ... ***[C]ash flows appear solid over the balance of the year and 2002; and their core Merchant Energy operating performance is solid.***

¶375.

The statements issued in 10/01 in the two CitiGroup analysts' reports were false and misleading. The true facts were that Enron's ***operating earnings*** for the 3rdQ 01 as reported were artificially inflated, as detailed herein, in part because of the huge dark-fiber swap transaction with Qwest; the write-offs taken by Enron on 10/16/01 did not clean up its balance sheet – in fact, there were ***billions of dollars of additional overvalued assets still on Enron's balance sheet***; and Enron's shareholder equity was still overstated by $1-$2 billion and Enron's previously reported earnings were grotesquely false as detailed herein. The forecasts of strong 01 operating EPS of $1.80 per share and 02 EPS of $2.15 for Enron were also completely false as there was no basis whatsoever for these forecasts as, in fact, Enron's business internally was collapsing and was riddled with huge

operating losses which were actually increasing but continuing to be concealed. In fact, Enron's liquidity was extraordinarily endangered. ¶390.[51]

Virtually all of CitiGroup's research reports on Enron were false for another reason. After LJM2 was formed and CitiGroup had secretly pre-funded LJM2 and been permitted to invest in LJM2 in 12/99 (ultimately to the tune of over $15 million), and CitiGroup became the major ($120 million) lender to LJM2 and administered LJM2's affairs and engaged in the Delta transactions with Enron, CitiGroup continued to issue very positive analyst reports on Enron. Each of these reports contained "boilerplate" disclosures like:

> Salomon Smith Barney ("SSB"), including its parent, subsidiaries and/or affiliates ("the Firm"), ... or employees preparing this report may have a position in securities or options of any company recommended in this report. An employee of the Firm may be a director of a company recommended in this report. The Firm may perform or solicit investment banking or other services from any company recommended in this report.

These boilerplate disclosures were the same as they were before 12/99 – i.e., they did not change in any substantive change after CitiGroup became an investor in LJM2 or loaned $120 million to LJM2 to finance its non-arm's-length transactions with Enron or engaged in the multi-billion dollar Delta transactions with Enron to inflate its reported profits and hide billions of dollars in debt.[52] The failure to disclose these matters made CitiGroup's "boilerplate" disclosure false and misleading and concealed from the market the very significant and serious conflict of interests which Enron and CitiGroup knew would have cast serious doubts on the objectivity and honesty of CitiGroup's analysts' reports on Enron and disclosed that CitiGroup or its executives had compromising ties to and serious conflicts of interest regarding Enron. ¶¶29, 687-692.

CitiGroup also made false and misleading statements in the 2/99 Registration Statement for the sale of 27.6 million shares of Enron stock. The 2/99 Registration Statement was false and

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[51] CitiGroup cites (improperly) two analyst reports on Enron dated 10/25 and 10/26 when it supposedly downgraded the stock as evidence that it was not a co-conspirator with Enron. First of all, conspiracy is not alleged. Second, those 10/25-26 reports are ***not*** alleged in the CC and cannot be considered at the 12(b)6 stage. Third, if the 10/25-26 reports show anything it is that very late in the game rats began to desert the sinking ship – something those in a fraudulent scheme often do when the scheme is unravelling. Dishonest actors try to save their own skins.

[52] Copies of relevant pages from pre- and post-12/99 CitiGroup analyst reports are attached as Ex. 5 to plaintiffs' Appendix.

misleading due to the incorporation Enron's 97 10-K and 98 10-Qs that contained Enron's ***admittedly false financial statements for 97-98, which understated Enron's debt by billions of dollars and overstated its earnings by hundreds of millions of dollars***, as detailed in ¶¶418-611 of the CC. The restatement of previously issued financial statements is an admission that they were materially false when issued and Enron has restated its 97, 98 and 99 results by huge amounts. While the Registration Statement included audited annual financial statements, significantly, it also incorporated or included all documents filed pursuant to §13(a) of the 1934 Act prior to the respective offerings, ***including Enron's 98 10-Qs which contained Enron's admittedly unaudited financial false and misleading unaudited quarter financial results***. ¶612.[53] Of course, since the interim financial statements are unaudited, they were not expertised, and CitiGroup is responsible for them.

The 7/23/99 Registration Statement used to sell Enron's 7% exchangeable notes was false and misleading due to the incorporation Enron's 98 10-K, the 3/31/99 10-Q, and its Recent Developments Section containing Enron's 6/30/98 results because these were Enron's ***admittedly false financial statements for 97-98 and the first six months of 99, which understated Enron's debt by billions of dollars and overstated its earnings by hundreds of millions of dollars***, as detailed in ¶¶418-611.

CitiGroup also made false statements in the Registration Statement used by Enron to sell New Power stock to investors in 10/00, a transaction that allowed Enron to create a bogus $370 million profit. The successful completion of this IPO was a key part of the scheme. New Power was purportedly a nationwide provider of electrical power and natural gas to retail consumers. New Power was formed by Enron in 99, and controlled by it. The New Power 10/00 Registration Statement represented that New Power could succeed in a volatile energy market (where other similar companies had failed) through sophisticated risk management strategies conceived and managed by its affiliate, EES. In fact, neither EES nor New Power had any hedging strategies which

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[53] While CitiGroup may be able at trial to establish a defense to liability for these expertised, *i.e.*, certified financial statements, in light of the CCs allegations that CitiGroup knew those annual certified financial statements were false, CitiGroup may not do so now at the 12b-6 stage. *Murphy*, 1996 U.S. Dist. LEXIS 22207, at *23.

could enable New Power to operate profitably under market conditions prevailing at the time of the IPO or, indeed, at any time thereafter. Indeed, in 8/01, nine months after the IPO, Margaret Ceconi, an EES executive, informed defendant Lay, a New Power director, that EES had failed for two years (*i.e.*, since in or about 99) in "***almost all***" of its energy sales purportedly involving hedging attempts, and had been reporting losses on hedging contracts as gains. *See* ¶42.

The New Power Registration Statement emphasized the skill and expertise Enron would provide in assisting the Company to economically obtain necessary power supplies, and to hedge against market volatility. The Registration Statement stated:

> We were formed by Enron Corp., the largest trader and marketer of electricity and natural gas in North America, to target the rapidly restructuring residential and small commercial markets for these products. ***We believe we are uniquely positioned to succeed because of our access to Enron's technical resources, regulatory and risk management expertise, and reliable wholesale commodity purchasing power.***

The Registration Statement also made it appear that Enron and its affiliates were long-term investors in New Power, and believed in its prospects for success. The Registration Statement failed to disclose that Enron and the underwriters anticipated that New Power's shares would decline from the IPO price, and had indeed acted on this belief. Enron had set up a partnership known as "Raptor III," whose purpose was to hedge Enron's position against the anticipated decline in New Power's stock. Although the Registration Statement purported to describe fully the relationship between Enron, its affiliates, and New Power, and all of their related party transactions, it failed to fully disclose these planned Raptor transactions, known as Hawaii 125-0.[54] The New Power IPO proceeds of $543 million were also purportedly sufficient for New Power to carry forward its business plan for at least 24 months. Given the conditions in the energy markets, and the history of EES, CitiGroup knew that such proceeds could not carry New Power through one year of successful operations, let alone 24 months.

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[54] Because Enron was a huge shareholder of New Power, the misrepresented or omitted facts had a positive impact on Enron's publicly-traded securities and helped artificially inflate their trading prices. The motivation to conceal these facts from the investing public was to enable New Power to raise money for a company operating in a market niche where economic conditions appeared to render successful operations close to impossible. Raising public money shifted the cost of New Power's inevitable business failure away from Enron (to the extent possible), and onto the shoulders of public investors.

As a result of these misrepresentations and omissions, Enron was able to sell New Power shares at an IPO price of $21 per share, ***allowing Enron to create and record a bogus $370 million profit*** in the 4thQ 00. As the true nature of New Power's business operations was revealed over the course of the next few months, its stock price collapsed. On 12/5/01, New Power announced that its contracts with Enron had been terminated. On 2/20/02, New Power admitted it was unable to operate as an independent company. By 2/26/02, New Power stock stood at only 90 cents per share!

VI. CITIGROUP ACTED WITH SCIENTER, *I.E.*, WITH "THE REQUIRED STATE OF MIND" AND HAD MOTIVES AND THE OPPORTUNITY TO DEFRAUD ENRON INVESTORS, AS IT MADE FALSE STATEMENTS, EMPLOYED DECEPTIVE ACTS AND MANIPULATIVE DEVICES AND CONTRIVANCES TO DECEIVE AND PARTICIPATED IN A FRAUDULENT SCHEME OR COURSE OF BUSINESS THAT OPERATED AS A FRAUD OR DECEIT ON PURCHASERS OF ENRON SECURITIES

CitiGroup can claim neither ignorance nor innocence with respect to the Enron debacle. CitiGroup had an extensive and extremely close relationship with Enron, during which it gained knowledge of the fraudulent scheme and took affirmative steps to further it. It participated in ***disclosed*** commercial loans and lending commitments of over $4 billion to Enron. CitiGroup also helped raise over $3.5 billion for Enron via six sales of Enron and Enron-related securities, sales often accomplished via false Registration Statements. CitiGroup also made disguised loans of $2.4 billion through the contrived and fraudulent Delta "swap" transactions for which it received premium interest rates 300 basis points above normal lending rates – a $70 million per year payoff for its participation in the falsification of Enron's financial condition, liquidity and creditworthiness. CitiGroup's relationships with Enron were so extensive that ***top officials*** of the bank constantly interacted with the very top executives of Enron, *i.e.*, Lay, Skilling, Causey, McMahon or Fastow, on an almost daily basis throughout the Class Period, discussing Enron's business, financial condition, financial needs and plans, partnerships, SPEs and future prospects. CitiGroup provided ***both*** commercial banking and investment banking services to Enron, CitiGroup helped structure and fund several of Enron's secretly controlled partnerships – including LJM2 and its SPEs – to facilitate illicit and contrived SPE transactions which falsified Enron's financial statements and misrepresented its financial condition. As a result of CitiGroup's participation in the fraudulent scheme, it received

huge underwriting and consulting fees, interest payments, commitment fees and other payments from Enron and related entities. CitiGroup was also permitted to invest $15 million in Enron's lucrative LJM2 partnership as a reward to it for its participation in this fraud, allowing it ***to directly profit from the looting of Enron*** that took place via the repeated non-arm's-length fraudulent LJM2/SPE transactions with Enron, transactions which it knew could continue only if Enron's stock continued to trade at high prices – above the so-called equity issuance trigger prices in the LJM2/SPE deals. ¶¶618-621, 686-687. At the same time, CitiGroup's ***securities analysts were issuing extremely positive – but false and misleading – reports on Enron, extolling Enron's business success, the strength of its financial condition and its prospects for strong revenue and earnings growth, helping to push Enron's stock higher. As alleged, this is intentional participation in the fraud.***[55]

Thus, CitiGroup engaged and participated in the fraudulent scheme and course of business in several ways and, in so doing, engaged in or made repeated contrivances, devices to deceive and made false and misleading statements. CitiGroup also "pre-funded" LJM2 on 12/22/99 with $1.5 million, which funded four critical 99 year-end deals to create phony profits for, and hide debt of Enron. CitiGroup continued to fund LJM2 during 00-01, with more secret equity money, plus a $120 million loan which enabled LJM2 to engage in repeated non-arm's-length deals with Enron to artificially boost its profits by hundreds of million of dollars while hiding billions of debt – deceiving the securities markets. During 00-01, CitiGroup also administered the LJM2 partnership – which included distributing the lush profits flowing from the looting of Enron to the LJM2 investors – including CitiGroup. CitiGroup also engaged in the New Power IPO, helping to structure and fund an SPE deal creating a huge phony $370 million profit for Enron in 10/00 – further artificially inflating Enron's profits and hiding more debt. ***Again, as alleged in the CC, this is intentional falsification of Enron's financial results – and thus participation in the fraud.***

In evaluating the adequacy of the scienter allegations against CitiGroup, it is important to keep in mind the different liability theories being alleged under §10(b) and Rule 10b-5 against CitiGroup. While the CC alleges that CitiGroup made false and misleading statements in

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[55] Because CitiGroup sold Enron securities pursuant to false and misleading Registration Statements, it faces 1933 Act §11 liability as to which no scienter is required. *See* 69 *supra*.

Registration Statements and analyst reports, CitiGroup's liability is ***not limited*** to those allegedly false and misleading statements. The CC also alleges CitiGroup's liability for ***its*** conduct in participating in the scheme to defraud or course of business that operated as a fraud and deceit on purchasers of Enron publicly traded securities. This distinction is important because ***if*** the CC fails to adequately allege the falsity of CitiGroup's own statements ***or*** CitiGroup's knowledge or reckless disregard of the falsity of those statements, the CC may still adequately allege that CitiGroup knowingly or recklessly employed deceptive acts or participated in the fraudulent scheme or course of business ***or vice versa***. These are distinct liability theories – one based on ***statements*** – the other based on ***conduct***, which can result in liability, either in combination or separately.

It is clear that for §10(b) or Rule 10b-5 liability to attach under either theory, ***scienter must be present***, *i.e.*, either intentional or reckless conduct. Thus, with respect to CitiGroup's alleged deceptive acts and participation in the fraudulent scheme or course of business, scienter would be adequately pleaded if the facts pleaded give rise to a "strong inference" that in committing those acts, CitiGroup acted with the "required state of mind," *i.e.*, it acted intentionally or recklessly. This would be so even if CitiGroup had no knowledge that its ***own statements*** in analysts' reports or Registration Statements were false and misleading, for as this Court has recognized, ***it is not necessary that a defendant have made a false statement to be liable under §10(b) or Rule 10b-5***. *Landry's*, slip op. at 9 n.12.

A defendant may be held liable for participating in a scheme to defraud if it has knowledge of the scheme and commits manipulative or deceptive acts in furtherance of it.[56] *See BMC Software*, 183 F. Supp. 2d at 885-86, 905, 915; *Cooper*, 137 F.3d at 624 ("Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme"); *First Jersey*, 101 F.3d at 1471; *Lemmer v. Nu-Kote Holding, Inc.*, No. 3:98-CV-0161-L, 2001 U.S.

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[56] Plaintiffs stress that the existence of the scheme and the banks' participation in it are highly factually-dependent questions that either should not be resolved on a motion to dismiss or should be resolved in favor of the plaintiffs. *Richardson*, 451 F.2d at 40 (Whether the defendant's conduct amounts to a manipulative or deceptive act "depends upon the facts and circumstances developed at trial.").

Dist. LEXIS 13978, at *26-*27 (N.D. Tex. Sept. 6, 2001); *Health Mgmt.*, 970 F. Supp. at 209; *Adam*, 884 F. Supp. at 1401; *ZZZZ Best*, 864 F. Supp. at 967-72. Recklessness satisfies the scienter requirement. *See Nathenson*, 267 F.3d 400.

Whether a defendant has engaged in a scheme to defraud (or whether the complaint has sufficiently alleged so) should be determined by viewing the defendant's conduct (or the allegations of the complaint) ***as a whole***. *See Blackie*, 524 F.2d at 903 n.19 (for scheme liability, complaint should not be fragmented into individual, isolated acts but should be considered as a single overall scheme to defraud); *cf. Affiliated Ute Citizens*, 406 U.S. at 151 ("Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes'") (quoting *Capital Gains Research*, 375 U.S. at 186).

It is axiomatic that with respect to scheme liability, a defendant may be liable for participating in a scheme even if it did not interact with all the other participants, was unaware of the identity of each of the other participants, did not know about the specific roles of the other participants in the scheme, did not know about or participate in all of the details of each aspect of the scheme, or joined the scheme at a different time than the other participants. *See United States v. Craig*, 573 F.2d 455, 483-84 (7th Cir. 1977) (scheme to defraud under mail fraud statute); *United States v. Elam*, 678 F.2d 1234, 1246 (5th Cir. 1982) (conspiracy); *United States v. Alvarez*, 625 F.2d 1196, 1198 (5th Cir. 1980) (*en banc*) (conspiracy).[57]

Scheme to defraud and conspiracy liability theories, while they share some similarities, are separate and distinct liability theories and the elements of the two theories are not identical. *See*

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[57] As the Supreme Court has stated with respect to conspiracy liability: "[T]he law rightly gives room for allowing the conviction of those discovered [to be participants in a conspiracy] upon showing sufficiently the essential nature of the plan and their connections with it, without requiring evidence of knowledge of all its details or of the participation of others. Otherwise ... conspirators would go free by their very ingenuity." *Blumenthal v. United States*, 332 U.S. 539, 557 (1947) (footnote omitted).

Plaintiffs cite these conspiracy cases not because they allege conspiracy liability here – they do not. However, since scheme liability is expressly provided for by the language of §10(b)/Rule 10b-5 and the extent of the scheme liability is ***at best as broad*** a conspiracy liability would be these conspiracy cases are useful in determining the parameters of scheme liability.

United States v. Read, 658 F.2d 1225, 1239 (7th Cir. 1981). Most significantly, a conspiracy requires an ***agreement*** and imposes liability based on the act of joining that agreement as well as on acts taken in furtherance of the conspiracy. *See id.* at 1240. A scheme to defraud, on the other hand, requires neither an agreement nor the joining of a scheme; liability is imposed based on using the mails or securities exchanges to further the fraudulent scheme. *See id.* Therefore, if knowledge of all the other details, activities and participants in a scheme is not essential for conspiracy liability, which requires an agreement among the participants, then such knowledge certainly is not necessary for scheme liability, which does not require an agreement.

A defendant who participates in a scheme to defraud is liable for the damages caused by all of the acts taken by the participants in the scheme in furtherance of the fraud. *See In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 627-29 & n.3 (N.D. Cal. 1995) (participants in scheme to defraud can be liable for statements made by others in the scheme); *Adam*, 884 F. Supp. at 1401 (same); *ZZZZ Best*, 864 F. Supp. at 968-72 (same); *SEC v. Nat'l Bankers Life Ins. Co.*, 324 F. Supp. 189, 194-95 (N.D. Tex. 1971), *aff'd*, 448 F.2d 652 (5th Cir. 1971) (same).[58] A scheme to defraud is a unitary violation, such that the plaintiff need not prove transaction causation with respect to any particular misrepresentations or omissions or other components of the scheme. *See Shores*, 647 F.2d

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[58] Similarly, under the federal mail fraud statute, 18 U.S.C. §1341, participants in a scheme to defraud are liable for the acts of the other participants in the scheme, even if the others committed the key acts. *See, e.g., United States v. Humphrey*, 104 F.3d 65, 70 (5th Cir. 1997); *United States v. Lothian*, 976 F.2d 1257 (9th Cir. 1992); *United States v. Maxwell*, 920 F.2d 1028, 1035 (D.C. Cir. 1990); *United States v. Lanier*, 838 F.2d 281, 284 (8th Cir. 1988); *United States v. Wiehoff*, 748 F.2d 1158, 1161 (7th Cir. 1984); *Craig*, 573 F.2d at 483-84.

This principle also applies to conspiracy liability. *See Read*, 658 F.2d at 1231-40 (conspirator liable for acts of co-conspirators even if statute of limitations has run on its own acts); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967) (conspiracy); *id.* at 267 n.2 (conspirator liable even for acts of co-conspirators occurring after its own last act); *In re Nissan Motor Corp. Antitrust Litig.*, 430 F. Supp. 231, 233 (S.D. Fla. 1977) (conspirator liable even for acts of co-conspirators occurring prior to its joining conspiracy).

The common law also recognized this, with respect to contributing tortfeasors or persons acting in concert, such as through a conspiracy or scheme. *See Restatement (Second) of Torts* §875 (1979) ("Each of two or more persons whose tortious conduct is a legal cause of a single and indivisible harm to the injured party is subject to liability to the injured party for the entire harm."); *id.* at §876(a) ("For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (a) does a tortious act in concert with the other or pursuant to a common design with him."); *id.* at §876, Comment a ("Whenever two or more persons commit tortious acts in concert, each becomes subject to liability for the acts of the others, as well as for his own acts.").

at 472 ("The concept of [a] scheme to defraud satisfies the requirement of 'transaction causation.' It has as its core objective that the potential victim engage in the transaction for which the scheme was conceived."); *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974); *ZZZZ Best*, 864 F. Supp. at 973 (to satisfy reliance requirement for scheme liability, it need only be shown that market relied on overall fraudulent scheme rather than on individual statements or omissions).

Nat'l Bankers Life, 324 F. Supp. at 193-94 – a pre-*Central Bank* case – recognized that participants in a scheme to defraud under Rule 10b-5 may be held liable for all of the acts involved in the scheme. In that case, the SEC brought an action against 28 defendants for participating in a conspiracy to defraud and a scheme to defraud. *See id.* at 193-94. Since this was a pre-*Central Bank* case, the SEC did not focus on the difference between conspiracy and scheme liability, treating them essentially as synonymous, and the court did not focus on the difference between primary violators and aiders and abettors, instead assuming that the SEC intended to hold the co-schemers liable as aiders and abettors rather than as primary violators. *See id.* at 195. But although the court considered the scheme liability of the defendants under the rubric of aiding and abetting, it could just as well have considered it under the rubric of primary liability. Nevertheless, the important point is the court's recognition that co-schemers may be liable for all aspects of the scheme:

> In the narrow sense, a defendant could have aided and abetted a particular fraudulent act under 10(b)(5)(2) or 10(b)(5)(3) or use of a particular device under 10(b)(5)(1) and thus be liable for only the results of that specific violation. In the more expansive sense, a defendant could have aided and abetted a ***general scheme*** under 10(b)(5)(1) and ***thus be liable for the results of all aspects of the scheme*** (assuming the scheme was a broad one).

Id.

As noted above, after *Central Bank*, a defendant may be held liable for participating in a scheme to defraud if it has knowledge and commits manipulative or deceptive acts in furtherance of it. Therefore, bringing the principle recognized in *Nat'l Bankers Life* in line with *Central Bank*, if a defendant with knowledge of a broad or general scheme to defraud commits manipulative or deceptive acts in furtherance of broad aspects of the scheme, the defendant may be held liable for

all of the results of the scheme. *See generally Central Bank*, 511 U.S. at 191 ("In any complex securities fraud, moreover, there are likely to be multiple violators ....").[59]

In evaluating the CC's allegations that CitiGroup employed acts and manipulative or deceptive devices and contrivances, and participated in a fraudulent scheme and course of business, it is important to focus on the ***type*** of actions CitiGroup has alleged to have committed in furtherance of the alleged fraudulent scheme or course of business. For instance, the phony Delta "swap" transactions are by their very nature intentional conduct. These multi-billion dollar, highly structured transactions which CitiGroup entered into with Enron, often at quarter-end, to conceal loans to Enron and allow Enron to boost its reported results, could not have been the result of negligence or

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[59] In *Lemmer*, 2001 U.S. Dist. LEXIS 13978, the plaintiffs alleged a scheme to defraud and sought to hold certain of the alleged participants liable for the fraudulent acts of the other participants in the scheme. *See id.* at *25. The court held that, ***on the particular facts of the case before it***, such attribution could not be made because the plaintiffs had failed to sufficiently allege either the existence of the scheme or the defendants' manipulative or deceptive acts in furtherance of it. *See id.* at *26-*27. For example, the sole allegations as to the existence of the scheme were "vague, general, and unsupported by specific details that might support a strong inference of such a scheme." *Id.* at *26. In addition, the complaint made ***no*** allegations regarding the manipulative or deceptive acts of nearly all the defendants in furtherance of the scheme. *See id.* The scheme allegations of the *Lemmer* complaint consisted entirely of the following provision:

> Each of the defendants actually knew the allegedly false statements about Nu-kote's business and future prospects were false and misleading when made. Each of the defendants is liable as a participant in a fraudulent scheme and course of business that operated as a fraud or deceit on purchasers of Nu-kote stock, including false and misleading statements and/or concealed material, adverse facts. The fraudulent scheme and course of business: (a) deceived the investing public regarding Nu-kote's products and business; (b) deceived the commercial markets regarding Nu-kote's success in integrating the Pelikan acquisition and developing new products; (c) created false financial results during the 4thQ of FY96 and the first three quarters of FY97; and (d) caused plaintiff and other members of the Class to purchase Nu-kote stock at inflated prices.

Id. at *26-*27. On these facts, the *Lemmer* court concluded that "[a]llowing such general, unsupported allegations of a fraudulent scheme, without any details that support a strong inference of such a scheme such as acts of participation by each of the Defendants, would vitiate the particularity requirements of the PSLRA." *Id.* at *27. In so finding, the court distinguished *Cooper*, 137 F.3d 616, in which the complaint was found to contain sufficient allegations of the defendant's participation in a scheme to defraud to support liability on that basis. *See* 2001 U.S. Dist. LEXIS 13978, at *26.

Unlike the complaint in *Lemmer*, and like the complaint in *Cooper*, the CC in this action includes specific, detailed and substantial allegations concerning both the existence of a scheme to defraud and the banks' participation in it through numerous manipulative and deceptive acts, as set forth above.

ignorance. Why do these loans and then contrive the transactions and disguise them as commodity trades via Cayman Island entities unless the purpose was to conceal and deceive, as alleged?

In this regard, CitiGroup participated in the pre-funding of LJM2 on 12/22/99 – putting up $1.5 million ***before*** LJM2 was fully formed or funded and putting up much more money than its allocated share of LJM2's equity was or would have been – to finance four phony, non-arm's-length year-end 99 deals with Enron, ***which were then all quickly unwound during 00, with huge returns to these LJM2 pre-funders. This is obviously intentional conduct – it was not and could not have been the result of negligence or inadvertence.***

With respect to CitiGroup's liability under §10(b) and Rule 10b-5 for its own false and misleading ***statements***, it is necessary for the CC to plead specific facts raising a "strong inference" that CitiGroup knew the statements were false or acted in reckless disregard of their truth or falsity. However, in this regard, CitiGroup's alleged conduct and its participation in the fraudulent scheme or course of business remain highly relevant, for those ***acts*** themselves can show CitiGroup's ***knowledge*** of the falsity – or its reckless disregard for the truth or falsity – of the ***statements*** it was making.

Again, CitiGroup's involvement in LJM2 – where it pre-funded LJM2 on 12/22/99 with $1.5 million, to enable LJM2 to engage in non-arm's-length fraudulent transactions with Enron in the last days of 99 to create bogus income and hide debt, shows that CitiGroup ***knew (or recklessly disregarded)*** that Enron's financial statements were false, its financial condition was being misrepresented and that its purported business success was not due to strong business conditions or the skill of its managers and the success of their risk management and hedging techniques, but rather to non-arm's-length fraudulent financial transactions with controlled entities. CitiGroup knew both because it was an investor in LJM2 ***and*** was administering LJM2's affairs, *i.e.*, distributing its profits to investors, that during 00-01 LJM2 was constantly engaging in transactions with Enron where Enron insiders (Fastow, Kopper and Glisan) were on ***both sides*** of the transactions and that the LJM2 partnership was extraordinarily lucrative – providing huge and indeed excessive returns to LJM2's investors – returns Skilling now says were only possible if the transactions were non-arm's-length and fraudulent, *i.e.*, due to the looting of Enron. In this regard, Skilling's recent testimony to the SEC

that – upon reviewing LJM2 documents that the returns the LJM2 investors got – ***it was immediately apparent to him*** – (a man who claims to lack financial sophistication) – that those returns from the deals LJM2 was getting via SPE deals with Enron were so huge – ***so lavish – that they had to be due to non-arm's-length fraudulent transactions is key***. According to *The New York Times*:

> ***Enron Ex-Chief Said to Voice Suspicion of Fraud***
>
> Jeffrey K. Skilling, the former chief executive of Enron, has told investigators that the top flight financial returns that investors made from a partnership that did business with the company could have been achieved only if the corporation was defrauded, according to documents and people involved in the case.... He indicated to the S.E.C. and to investigators for a special committee of the Enron board that such returns – which were as high as 2,500 percent in one transaction – could not have been achieved through arm's-length transactions, according to these people and investigative notes.
>
> When shown records that laid out the details of the financial returns during his testimony several months ago before the S.E.C., ***Mr. Skilling was said to have grown agitated as he described his opinion of the information. Had he known the magnitude of the profits, Mr. Skilling was said to have told the regulators, he would have immediately summoned Enron executives involved in the dealings and given them 24 hours to justify such outsize results***.

Kurt Eichenwald, "Enron Ex-Chief Said to Voice Suspicions of Fraud," *New York Times*, 4/24/02.[60]

What does this testimony say about the knowledge of a financially sophisticated bank like CitiGroup's which was reaping the very fruits of those fraudulent non-arm's-length LJM2 transactions as they and Fastow looted Enron for their own gain!

These favored investors in LJM2, ***like CitiGroup***, actually ***witnessed*** and ***benefitted from*** a series of extraordinary payouts from the LJM2-controlled SPEs – securing hundreds of millions of dollars in distributions from the SPEs to LJM2 and ***then huge returns/profits to themselves from LJM2 – cash generated by the illicit and contrived transactions Enron was engaging in with the LJM2 SPEs to falsify its financial results***. Thus, CitiGroup ***was not only a knowing participant in the Enron scheme to defraud, it was a direct economic beneficiary of it and the looting of Enron***. ¶¶31, 649

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[60] If poor Mr. Skilling, who has publicly protested his lack of financial sophistication could immediately figure out ***LJM2 was a vehicle to defraud Enron, then it is a reasonable inference that sophisticated bankers, like CitiGroup, who were actually reaping these fantastic returns, knew it all along***.

Assuming these allegations are true, then how was it possible for CitiGroup to be making the kind of extremely positive statements in its analysts' reports about the strong economic performance of Enron's various businesses, the skill and talent of its management team, the strength of its core businesses, as well as forecasting strong continuing earnings growth over the next several years unless CitiGroup was deliberately lying or had simply closed its eyes in the blind pursuit of Mammon.

Livent, 174 F. Supp. 2d 144, shows that scienter has been well alleged here. In *Livent*, purchasers of Livent securities sued Livent's commercial and investment bank (CIBC) for violations of 1933 Act §11 and 1934 Act §10(b)/Rule 10b-5. The court also sustained the adequacy of the §10(b)/Rule 10b-5 claims – finding the bank's participation in "***Livent's fraudulent scheme***" was adequately pleaded. The key allegation was that CIBC made a $4.6 million payment to Livent in return for theatrical royalties, which in reality was a secret "bridge" loan to Livent, as CIBC had a secret side agreement from Livent to "repurchase" the advance in six months for $4.6 million, plus interest – the "CIBC Wood Gundy Agreement." This was a fraudulent contrivance because Livent improperly recorded income on the transaction, but did not record the loan. The district court held scienter was adequately alleged, stating:

> It does not require an unreasonable inferential leap to conclude, as the Noteholders suggest, that in entering into the bridge loan transaction and secret side agreements with Livent, CIBC, as Livent's investment bankers since 1993, ***had acquired substantial knowledge of Livent's real financial condition and was aware of Livent's reasons to account for the $ 4.6 million "non-refundable fee" as a revenue-generating investment rather than a repayable loan***....
>
> Significantly, according to the complaint, the proceeds from the alleged fraudulent arrangement were reported by Livent as current revenue in its accounts and public registration statements in order ***[to] [sic] create a false financial basis to reinforce and ensure the success of Livent securities issues intended in part to repay Livent's substantial debt to CIBC.***
>
> From these allegations, ***it is fair to infer that in entering into the CIBC Wood Gundy Agreement, CIBC was aware not only that Livent contemplated marketing securities on the basis of public representations of its financial condition that Livent knew to be false, but that CIBC itself subsequently undertook to solicit and sell the very securities whose value incorporated and was affected by the falsehood CIBC itself had conceived with Livent. In this manner, CIBC's participation in Livent's fraudulent scheme went beyond a passive capacity as Livent's investment banker and financial adviser.***
>
> * * *

> ***The Noteholders have pled facts suggesting that CIBC became part and parcel of Livent's misleading statements by entering into a loan transaction whose true character and financial implications it agreed not to disclose.*** This financial interest and complicity not only assisted Livent in concealing critical information, it also committed CIBC to similarly withhold the truth from investors with whom it dealt in Livent securities, a commitment that effectively conflicted with any applicable duty CIBC had to disclose material facts in connection with subsequent public sales of such securities affected by the transaction.
>
> ***Rather than generally reflecting the profit motive of any securities dealer, the concrete benefit derived by CIBC from Livent's fraud alleged here was uniquely personal to CIBC in several ways. Only CIBC, as Livent's investment bankers since 1993, is alleged to have had a longstanding, intimate relationship with Livent executives that offered it uncommon opportunity to know of, and play an active role in Livent's, financial affairs. And only CIBC is accused, in furtherance of its own motives, of assisting Livent in structuring and keeping secret the misrepresented CIBC Wood Gundy Agreement. Later, in publicly marketing Livent securities whose value partly depended on the true nature of that agreement, CIBC stood to realize gains particular to it. Beyond the standard fees and commissions associated with any investment bank's sales of securities. CIBC had a higher stake in Livent's public financings. It uniquely benefitted from the application of the proceeds of the Notes sales to Livent's considerable debt to CIBC.***

The facts in this case closely mirror the facts in *Livent*. Indeed, the only noteworthy difference between this case and *Livent* is that the defendants in *Livent* entered into only one secret loan transaction in furtherance of their fraudulent scheme. In this case, the defendants entered into numerous concealed transactions, including secret loans, that were hidden from investors. The similarities between the investment bank defendants' ***scienter*** is clear. In *Livent*, CIBC knew of a secret side-letter agreement it signed with Livent that enabled Livent to avoid reporting a loan on its books; thus, (the court found) CIBC must have known that Livent's reported financial condition was not its "real financial condition." *See Livent*, 174 F. Supp. 2d at 151. Here, for example, CitiGroup knew that it was disguising loans as prepaid swaps when it structured the Delta transactions for Enron, which enabled Enron to avoid reporting the loans on its books (¶684); thus, CitiGroup (one must infer) knew that Enron's reported financial condition was not its "real financial condition." Like the court in *Livent*, this Court should also find that the investment bank defendant here acted with ***scienter*** in structuring secret loans such that they would not have to be reported to shareholders, and therefore is liable for participation in a fraudulent scheme.

In evaluating the CC's allegations of knowledge on the part of CitiGroup, it is important to appreciate that the banks named as defendants in this case, including CitiGroup, are very ***different***

financial institutions from the investment banks or commercial banks that may have been named as defendants in prior securities cases. Until recent years, investment banks were ***not*** permitted to engage in commercial bank lending and commercial banks were not permitted to engage in investment banking services. This was the essence of Glass-Steagall. However, when Glass-Steagall was repealed, most banks, including the banks named as defendants in this case quickly morphed into "financial services institutions" and began to offer both commercial and investment banking services.

This change in the nature of the operations of the banks named as defendants in this case has important implications for the CC's allegations that they knew or were reckless in not knowing that the statements they were making about Enron to investors were false and misleading. Because these banks were making huge commercial loans to Enron, ***as well as*** participating in securities offerings by Enron and related entities, they had much broader and more constant contact with Enron's top executives and access to Enron's non-public financial records, performance and plans than would have been the case had they only come periodically into contact with Enron to act as an underwriter to sell securities to the public.

During the Class Period, CitiGroup was a major lender to Enron, being involved in over $4 billion in loans or lending commitments, not including the $2.4 billion in disguised loans via Delta. In making large commercial loans or commitments as CitiGroup did to Enron, CitiGroup was required, not only by federal laws and regulations but by its own internal procedures, ***to engage in an extremely detailed review and analysis of the actual financial condition and creditworthiness of the borrower, not only at the outset when the loan, is made but constantly throughout the pendency of the loan or lending commitment.*** Obviously, the larger the size of the loan or loan commitment, the greater the amount of financial analysis oversight and review required.

Thus, CitiGroup was required to perform extensive credit analysis of Enron after obtaining detailed financial information from it. Included in this credit analysis was a detailed review of the Enron's actual and contingent liabilities, its liquidity position, any equity issuance obligations it may have which could adversely affect its shareholders' equity, any debt on which Enron may have been potentially liable, even if not on Enron's books directly, the quality of Enron's profits and earnings

and Enron's actual ***liquidity***, including sources of funding to support repayment of any loans. In addition, after CitiGroup made large loans to or committed itself to credit facilities for a corporation, ***it was required to closely monitor Enron by frequently reviewing its financial condition and ongoing operations for any material changes and insist that top financial officers of the borrower keep it informed of the current status of the borrower's business and financial condition***. As a result, CitiGroup obtained extremely detailed information concerning the actual financial condition of Enron throughout the Class Period and knew that the actual condition of Enron's business, its finances and its financial condition was far worse than was being publicly disclosed by Enron, or as described or disclosed in each of CitiGroup's analyst reports on Enron. Thus, CitiGroup knew (or was reckless in not knowing):

(a) Enron had set up LJM2 at year-end 99 so that Enron could use SPEs funded by that vehicle to engage in non-arm's-length self-dealing transactions which would enrich the investors in the LJM2 partnership – including CitiGroup – and, at the same time, permit Enron to generate artificial profits and conceal its true debt level by moving billions of dollars of debt off its balance sheet and onto the balance sheet of LJM2's SPEs;

(b) Enron was also engaging in similar non-arm's-length transactions with another limited partnership, JEDI, and an associated SPE known as Chewco, which was also permitting Enron to artificially inflate its reported earnings while moving large amounts of debt off its balance sheet;

(c) Enron's actual financial condition and results from operations were far worse than what was being publicly disclosed or presented: (i) because Enron was falsifying its financial results and misusing and abusing mark-to-market accounting, resulting in Enron's profitability being far less than publicly reported; (ii) because Enron was improperly moving debt off its balance sheet and onto the balance sheets of entities it secretly controlled, Enron's true debt level and leverage was much higher than what was being publicly presented; and (iii) because of the foregoing, Enron's liquidity and creditworthiness were far worse than publicly known and its financial condition much more leveraged and precarious than was being disclosed to public investors; and

(d) Enron had entered into a number of transactions with secretly controlled SPEs being funded by LJM2 which CitiGroup was funding – while administering its affairs – to finance these transactions, which would require Enron to issue millions of shares of Enron common stock. If Enron's common stock fell below trigger prices ranging from $83-$19 per share, not only would Enron be required to issue huge amounts of additional stock, also, the debt of the SPEs with which Enron was doing business would not, in fact, be non-recourse to Enron as represented but, in fact, would become and be recourse to Enron if, as and when Enron's credit rating was lowered – something CitiGroup knew would occur if, as and when Enron's true financial condition became public or became known to the rating agencies. In addition to CitiGroup's extensive ongoing commercial banking relationship with Enron – and the knowledge it gained from that – CitiGroup also acted as an underwriter in six securities offerings, raising $3.5 billion for Enron before and during the Class Period.

Thus, CitiGroup had ***constant access*** to Enron's top executives and Enron's financial records, finances, plans, etc. ***in connection with a series of large ongoing major commercial loans and/or lending commitments, as well as several securities offerings between 98 and 01***! Thus, this is ***not*** a situation of alleging scienter against a bank that had only isolated contact with an issuer in the context of doing limited due diligence only in connection with a single or few securities offerings. Here, what is alleged, is (i) ***constant access by a sophisticated commercial lender to the innermost details of the financial structure and operations of a company that was a major borrower from the commercial operations of the bank, which (ii) was also making billions of dollars of disguised and concealed loans to the buyer via contrived "swap" deals, and which; (iii) via the bank's investment banking operations was selling securities of the company to the public; and (iv) was also constantly issuing analyst reports about that borrower/client to the public; (v) while the bank was secretly investing in a huge partnership (LJM2) which was doing non-arm's-length fraudulent transactions with Enron which were generating hundreds of millions of dollars of phony profits, while hiding billions of dollars of Enron's actual debt and generating massive returns to the bank, as its secret investment in the LJM2 partnership benefitted from the looting of Enron, while (vi) was acting as administrator of the affairs of the illicit LJM2 partnership***

distributing its lush and excessive profits to the funders – like CitiGroup. With all due respect, this is a situation that has never before been presented since the passage of the federal securities laws in 1933-34 because only in recent years have banks been able to engage in the kind of joint commercial and investment banking activity present in this case and which apparently was so abused by them to the great damage of purchasers of Enron's publicly traded securities.

In interacting with Enron, CitiGroup functioned as an unified entity. There was no so-called "Chinese Wall" to seal off the CitiGroup securities analysts from the information which CitiGroup obtained rendering commercial and investment banking services to Enron. Alternatively, even if some restrictions on the information made available to CitiGroup's securities analysts existed, those unilateral and self-serving actions are insufficient to prevent imputation of all knowledge and scienter possessed by the CitiGroup legal entity, as its knowledge and liability in this case is determined by looking at CitiGroup as an overall legal entity. ¶676.[61]

Knowledge is imputed to a corporation through its employees and agents via *respondeat superior*. To determine the *mens rea* of a corporation, courts not only consider the actual knowledge of each individual employee, but also aggregate each employee's knowledge under a theory referred to as the "Collective Knowledge Doctrine."

The Fifth Circuit has clearly found in favor of applying traditional notions of *respondeat superior* to impute knowledge to a corporate defendant in both civil and criminal proceedings. *Standard Oil Co. v. United States*, 307 F.2d 120, 127 (5th Cir. 1962). Furthermore, "'[w]hether the corporate officer or agent was possessed of actual knowledge of facts is ordinarily (a question) of fact for the jury. Whether the knowledge of, or notice to, an officer of a corporation is to be imputed to the corporation is a question of law for the court.'" *Am. Standard Credit, Inc. v. Nat'l Cement Co.*, 643 F.2d 248, 270 (5th. Cir. 1981).

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[61] Any claimed "Chinese Wall" cannot provide a defense at the motion to dismiss stage. *Cooper*, 137 F.3d at 628-29.

While *Standard Oil* does not limit the imputation of knowledge to high-level employees, [62] subsequent Fifth Circuit cases do appear to focus much more on the employee's position in the company. *See In re Hellenic Inc.*, 252 F.3d 391, 395 (5th Cir. 2001) ("[W]e have observed that the question of 'privity or knowledge must turn on the facts of the individual case,' stating that a corporation 'is charged with the privity or ***knowledge of its employees when they are sufficiently high on the corporate ladder***.' We have further explained that privity or knowledge 'is imputed to the corporation when the employee is an executive officer, manager or superintendent whose scope of authority includes supervision over the phase of the business out of which the loss or injury occurred.'") (footnote omitted).

The First Circuit has detailed the Collective Knowledge Doctrine and its justifications as such:

> [Defendant] Bank contends that the trial court's instructions regarding knowledge were defective because they eliminated the requirement that it be proven that the Bank violated a known legal duty. It avers that the knowledge instruction invited the jury to convict the Bank for negligently maintaining a poor communications network that prevented the consolidation of the information held by its various employees. ***The Bank argues that it is error to find that a corporation possesses a particular item of knowledge if one part of the corporation has half the information making up the item, and another part of the entity has the other half.***
>
> ***A collective knowledge instruction is entirely appropriate in the context of corporate criminal liability***. *Riss & Company v. United States*, 262 F.2d 245, 250 (8th Cir. 1958); *Inland Freight Lines v. United States*, 191 F.2d 313, 315 (10th Cir. 1951); *Camacho v. Bowling*, 562 F. Supp. 1012, 1025 (N.D. Ill. 1983); *United States v. T.I.M.E.-D.C., Inc.*, 381 F. Supp. 730, 738-39 (W.D. W.Va. 1974); *United States v. Sawyer Transport, Inc.*, 337 F. Supp. 29 (D. Minn. 1971), *aff'd*, 463 F.2d 175 (8th Cir. 1972). The acts of a corporation are, after all, simply the acts of all of its employees operating within the scope of their employment. The law on corporate criminal liability reflects this. *See, e.g., United States v. Cincotta*, 689 F.2d 238, 241, 242 (1st Cir.), *cert. denied*, 459 U.S. 991, 103 S. Ct. 347, 74 L. Ed. 2d 387 (1982); *United States v. Richmond*, 700 F.2d 1183, 1195 n.7 (11th Cir. 1983). ***Similarly, the knowledge obtained by corporate employees acting within the scope of their employment is imputed to the corporation***. *Steere Tank Lines, Inc. v. United States*, 330 F.2d 719, 722 (5th Cir. 1964). Corporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components.

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62 "***[N]o contention is made that 'knowledge' can be acquired only through supervisory or executive personnel***. On the contrary, while status of the actor in the corporate hierarchy might well have decisive significance in determining the question we later discuss concerning the intention to benefit the corporation, the corporation may be criminally bound by the acts of subordinate, even menial, employees.... ***Likewise, no contention is, or can at this late date, be made that mere violation of instructions would shield the corporation from criminal responsibility for actions which its agents have taken for it.***" *Standard Oil*, 307 F.2d at 127.

> ***The aggregate of those components constitutes the corporation's knowledge of a particular operation. It is irrelevant whether employees administering one component of an operation know the specific activities of employees administering another aspect of the operation:***
>
> > ***"[A] corporation cannot plead innocence by asserting that the information obtained by several employees was not acquired by any one individual who then would have comprehended its full import. Rather the corporation is considered to have acquired the collective knowledge of its employees and is held responsible for their failure to act accordingly."***
>
> *United States v. T.I.M.E.-D.C., Inc.*, 381 F. Supp. at 738. Since the Bank had the compartmentalized structure common to all large corporations, ***the court's collective knowledge instruction was not only proper but necessary.***

United States v. Bank of New England, N.A., 821 F.2d 844, 855-56 (1st Cir. 1987).

This District Court has explicitly endorsed the Collective Knowledge Doctrine. *See Burzynski v. Aetna Life Ins. Co.*, No. H-89-3976, 1992 U.S. Dist. LEXIS 21300, at *13 (S.D. Tex. Apr. 1, 1992) ("[T]he knowledge of Aetna's agents and employees is imputed to the corporation under the doctrine of '***collective knowledge***.'") (citing *Steere Tank Lines, Inc. v. United States,* 330 F.2d 719, 722 (5th Cir. 1963)).[63]

Also, knowledge held by one corporation prior to a merger with another corporation is carried over to, *i.e.*, imported to the successor succeeding entity. In *United States v. Wilshire Oil Co.,* 427 F.2d 969 (10th Cir. 1970), defendant Wilshire purchased another asphalt distributor, Riffe Petroleum Co., which then became an unincorporated division of Wilshire Oil Co. Prior to the merger, Riffe, acting through its agent, entered into a conspiracy to fix the price of asphalt sold to Kansas' highway departments. This conspiracy was alleged to have continued after Riffe was purchased by Wilshire and hence, Wilshire was indicted (and ultimately convicted) for conspiracy to violate the Sherman Act. Wilshire claimed on appeal that "the only knowledge it could have had regarding [its] participation in the conspiracy was ***knowledge acquired prior to the merger*** and [it was] thereby

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[63] Additionally, in *Am. Standard Credit*, 643 F.2d at 271 n.16, the Fifth Circuit stated: "'The general rule is well established that a corporation is charged with constructive knowledge, regardless of its actual knowledge, of all material facts of which its officer or agent receives notice or acquires knowledge while acting in the course of his employment within the scope of his authority, even though the officer or agent does not in fact communicate his knowledge to the corporation.'"

liable for neither the pre-merger crime nor [its] post-merger involvement." *Id.* at 973. The court of appeals rejected Wilshire's "novel" argument, stating:

> We pause to note that the argument does not deny that an agent's knowledge is imputed to the corporation if gained while acting in the scope of employment. The proposition merely suggests that Wilshire is immune from prosecution here because of a fortuitous series of events which placed them at the scene after the acquisition of the agent's information.
>
> There is no question about the continuing nature of the plot nor is there reasonable doubt that Wilshire was a part thereof. And we believe the ticklish problem of pre-merger knowledge must be decided against Wilshire on the facts. Although appellant claims to have unwittingly bought into an on-going conspiracy and for that reason it ought to be excused, the totality of the evidence supports the conclusion that Wilshire had ample opportunity to detect and reject the illegal practices. This is not a case where a company was purchased without chance for scrutinizing observation prior to assumption of control.

Id. at 973-74.

Of course, motive and opportunity remain relevant considerations in determining if scienter has been adequately alleged. CitiGroup had very strong economic motives to employ acts and contrivances to deceive and participate in the fraudulent scheme or course of business. For instance, the proceeds of Enron's securities offerings underwritten by CitiGroup or other investment banks were utilized to repay Enron's existing commercial paper and bank indebtedness, including indebtedness to CitiGroup. And throughout the Class Period, CitiGroup was pocketing millions of dollars a year in interest payments, syndication fees and investment banking fees by participating in the Enron scheme ***and huge returns on its secret investment in LJM2*** – returns created by the looting of Enron via the very manipulative or deceptive acts and contrived transactions between Enron and LJM2 entities which CitiGroup was financing to defraud and stood to ***continue*** to collect these huge amounts going forward, so long as it helped perpetuate the Enron Ponzi scheme. ¶646.

CitiGroup was willing to participate in the fraudulent scheme and course of business because its participation created enormous profits ***for CitiGroup as long as the Enron scheme continued in operation*** – something that CitiGroup was in a unique position to cause. While CitiGroup was lending hundreds of millions of dollars to Enron or had committed to lend hundreds of millions to Enron, it was limiting its own risk in this regard, as it knew that so long as Enron maintained its coveted investment grade credit rating and continued to report strong earnings and credibly forecast

strong ongoing revenue and profit growth, ***Enron's access to the capital markets would continue to enable Enron to raise hundreds of millions, if not billions, of dollars of fresh capital from public investors which would be used to repay or reduce Enron's commercial paper debt and the loans from CitiGroup to Enron so that the scheme could continue.*** ¶683.

No one had a greater motive than those who were secretly looting Enron, *i.e.*, Fastow and Enron's banks and bankers, to deceive investors as to the true state of Enron's financial condition and business prospects because that deceit was central to preserving Enron's access to public capital markets and keeping Enron's stock price inflated because that inflated stock price was the key supporting non-arm's-length fraudulent LJM transactions with SPEs that were enriching the banks and bankers. The involvement of CitiGroup in LJM2 was, bluntly put, a reward – a payoff – for its participation in the fraudulent scheme and one that they would continue to profit ***from as long as the Enron Ponzi scheme could be continued*** – generating huge returns for them as secret private equity investors in LJM2 ***which returns were only possible because the transactions that were being constantly entered into with Enron were non-arm's-length and fraudulent – generating bogus profits for Enron while hiding debt and at the same time generating excessive returns for LJM2 with Fastow, Enron's CFO, operating the levers on both sides of all deals***.

Simply put, CitiGroup which was involved in LJM2, was engaged in looting Enron for its own personal profit. This gave them a tremendous motive to keep Enron afloat and its stock price inflated so that Enron could consistently go back, with their help, to the capital markets to raise capital to keep the Enron Ponzi scheme going. While the banks may now whine about the losses they claim to have suffered when the Enron Ponzi scheme collapsed, they were secretly rubbing their hands in glee during the years that the scheme succeeded and Enron was being looted while being propped up with public money which was flowing into their dirty hands and then their own deep pockets. ***And the longer Enron could be propped up and the Ponzi scheme continue, the longer CitiGroup could continue to pocket these huge returns*** from such transactions.

Then add to this mix the huge investment banking fees, interest charges, lending commitment fees, etc., CitiGroup was extracting from Enron by helping to keep the Ponzi scheme going, either lending money to Enron to liquify Enron or by raising money from the public to liquify Enron, and

then using money raised from public investors to repay itself or other banks. ***These were huge securities offerings*** – $250 million in notes sold in 9/98; $870 million raised from the sale of common stock in 2/99; $370 million raised for Enron via the Azurix IPO in 6/99; $222 million raised for Enron via the sale of notes in 8/99; and $1.9 billion raised from the sale of 0% convertible notes in 2/01. While the investment banking fees to be gained in an isolated securities offering by an investment bank which does not have an ongoing relationship with the issuer may not, in and of itself, create sufficient weight to show a motive to defraud – surely the size and the continuity of the investment banking fees here, especially when combined with the fees being obtained from the bank's commercial activities in the context of the bank's secret involvement in the LJM2 partnership must be given great weight vis-à-vis motive. After all, a complaint is to be construed in its entirety and the inferences are to be drawn in favor of the plaintiff.

CitiGroup claims that it lost money at the end of the day when the Ponzi scheme collapsed. But this argument actually cuts against them. Like a gambler at the craps table who has a long run of good luck, but keeps doubling-up and ends up with a huge amount of chips at work on the table when he finally rolls a seven, CitiGroup did very, very well for itself and its top executives as long as the run of good luck continued, *i.e.*, the Enron house of cards stood. But, they paid the price when seven came up. In fact, as the financial exposure of the banks to Enron increased as the scheme progressed, ***it only increased the motive of the banks, like CitiGroup, to keep Enron looking good and keep its stock price up so that its increasingly fragile financial structure would not collapse and so that Enron would continue to have access, with the help of the banks, to the capital markets to raise monies to pay back Enron's debts to the bank.***

At the end of the day, the scienter allegations against the banks in the CC are uniquely strong in part because of the unique circumstances of this case. The banks named as defendants here chose to vastly expand the types of business they did with Enron and types of commercial transactions they engaged in with Enron. In so doing, they entangled themselves in the affairs of the company that was committing the largest and worst securities fraud in the history of the United States. The banks chose to facilitate and participate in that fraud – and to make false and misleading statements because it gave them – the banks and their top executives – the opportunity to reap huge profits. Having top

bank executives and banks secretly invest millions of dollars in partnerships that engage in non-arm's-length fraudulent transactions with a public company to loot it, while creating hundreds of millions of dollars of phony profits and hiding billions of dollars of debt, while the banks were secretly engaging in other bogus transactions with the public company, further artificially boosting its reported earnings and hiding additional billions of dollars of debt and all the while issuing glowing analysts' reports praising the skill and integrity of the company's management, the tremendous successes of its core businesses, the success of its risk management and hedging techniques, and its wonderful future business and earnings prospects, is simply not banking business as usual. Or if it is, this country and our financial markets are in terrible trouble.

VII. CONCLUSION

As this Court knows, a key Andersen partner condemned the LJM2 partnership – in an e-mail once destroyed, but later resurrected. According to *The New York Times*, 5/10/02 "Andersen Lawyer Accuses Prosecutors of Misconduct":

> ... [I]n one e-mail message written by Mr. Neuhausen [an Arthur Andersen partner] ... he lambasted Enron's plan to allow its chief financial officer to run a partnership that did business with the company, calling it terrible and asking, "***Why would any director sign off on such a scheme***?"

Indeed. And how could any sophisticated bank have gone in on such a "scheme"? The answer to Neuhausen's question is greed and arrogance – qualities that were present in abundance in Enron's insiders, its outside directors, its lawyers, accountants and banks.

On 2/26/02, *Dow Jones News Service* ran a story headlined: "***Next Stop On Enron Express: Wall Street***." It noted the "***long gravy train of stock and bond offerings that Enron sent the Streets' way over the past decade***." It also discussed:

> [T]he now-infamous LJM2 partnership set up by Enron's former chief financial officer, Andrew Fastow. It's been well-documented now ... that high-powered finance firms such as CS First Boston, Merrill Lynch, JP Morgan and Citigroup, were lured into the LJM2 partnership by the promise of potentially rich returns and the chance to get an inside peek into Enron's mysterious deals.
>
> * * *
>
> ... ***Wall Street – which got rich touting Enron – is still acting as if it has nothing to answer for in the Enron mess***.

So far, most Wall Street institutions have said little about the Enron debacle, issuing either blanket "no comments," or denying any responsibility for the company's collapse. CS First Boston, which underwrote more than $4.5 billion in Enron stock and bond offerings – roughly 20% of Enron's total underwriting work since 1990 ... has refused to say anything whatsoever. Merrill Lynch, which lined up investors for Fastow's LJM2 partnership and underwrote more than $4 billion in stock and bond offerings for Enron, has been a bit more talkative – ***but only to say it's utterly blameless***.

* * *

Between them, Citigroup and J.P. Morgan served as lead manager on more than $20 billion in syndicated bank loans to Enron over the past decade, with Citigroup also underwriting more than $4 billion in stock and bond offerings for the company ....

... Wall Street has plenty of explaining to do. Jonathan Kord Lagemann, a securities lawyer and former general counsel for a brokerage firm, says the Enron affair exposes the ***"enormous conflict of interest" inherent in these firms' efforts to be three things at one time: underwriter, corporate analyst and stock seller***. To start, there's the obvious issue of whether pressure from their firms caused 10 of the 14 research analysts who followed Enron to keep recommending the stock to investors, even as the company was racing toward bankruptcy. A related issue is whether the analysts knew or should've known just how dire the situation was at Enron, since many of them work for firms that were invested in the partnerships that played a critical role in Enron's off-balance-sheet transactions.

¶645. The blatant self-dealing by Enron's banks has not gone unnoticed:

Many institutional investors declined to buy into LJM2 because of Fastow's conflict of interest. But some of the world's biggest institutions took a piece. Among them ***were Citigroup, Credit Suisse Group, Deutsche Bank, JP Morgan, and Lehman Brothers.***

What were they thinking? Much of the world's financial community turned out to be willing enablers of Enron. No wonder "Wall Street credibility" is fast becoming an oxymoron. Investors are angry ....

Business Week, 2/11/02 (¶648).

The CC is not a blunderbuss long winded journey to nowhere. It is a thoroughly investigated detailed blueprint of CitiGroup's factual culpability which states a claim upon which relief can be granted under accepted legal theories.

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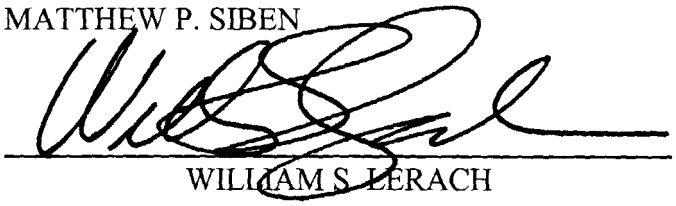
Respectfully submitted,

MILBERG WEISS BERSHAD
HYNES & LERACH LLP
WILLIAM S. LERACH
DARREN J. ROBBINS
HELEN J. HODGES
BYRON S. GEORGIOU
G. PAUL HOWES
JAMES I. JACONETTE
MICHELLE M. CICCARELLI
JAMES R. HAIL
JOHN A. LOWTHER
ALEXANDRA S. BERNAY
MATTHEW P. SIBEN



WILLIAM S. LERACH

401 B Street, Suite 1700
San Diego, CA 92101
Telephone: 619/231-1058

MILBERG WEISS BERSHAD
HYNES & LERACH LLP
STEVEN G. SCHULMAN
SAMUEL H. RUDMAN
One Pennsylvania Plaza
New York, NY 10119-1065
Telephone: 212/594-5300

Lead Counsel for Plaintiffs

SCHWARTZ, JUNELL, CAMPBELL
& OATHOUT, LLP
ROGER B. GREENBERG
State Bar No. 08390000
Federal I.D. No. 3932

ROGER B. GREENBERG

Two Houston Center
909 Fannin, Suite 2000
Houston, TX 77010
Telephone: 713/752-0017

HOEFFNER BILEK & EIDMAN
THOMAS E. BILEK
Federal Bar No. 9338
State Bar No. 02313525
Lyric Office Centre
440 Louisiana Street, Suite 720
Houston, TX 77002
Telephone: 713/227-7720

Attorneys in Charge

BERGER & MONTAGUE, P.C.
SHERRIE R. SAVETT
1622 Locust Street
Philadelphia, PA 19103
Telephone: 215/875-3000

Attorneys for Staro Asset Management

WOLF POPPER LLP
ROBERT C. FINKEL
845 Third Avenue
New York, NY 10022
Telephone: 212/759-4600

SHAPIRO HABER & URMY LLP
THOMAS G. SHAPIRO
75 State Street
Boston, MA 02109
Telephone: 617/439-3939

Attorneys for van de Velde

THE CUNEO LAW GROUP, P.C.
JONATHAN W. CUNEO
MICHAEL G. LENETT
317 Massachusetts Avenue, N.E.
Suite 300
Washington, D.C. 20002
Telephone: 202/789-3960

Washington Counsel